Bennett Jones

Fall 2020 Economic Outlook

Time for a Reboot

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"As we prepare for a post-pandemic world, we have to reassess where we are at, and plan next steps on how and where to go on offence. Like it or not, the economy is changing considerably. We need to pivot towards new industries, adjust on others, and define what full strength will look like, and lean into high payoff activities.

Because of the effects of COVID and the quarantine, we are on the border of uncertainty—maybe a new paradigm. Yet we have to remain entrepreneurial and take risks. We could hunker down and build a fortress on the edge of the known, or break out into the unknown. One thing is for sure, recent events have accelerated change. Staying ahead of the curve and making the best course corrections will require the vision and creativity of everyone."

Hugh MacKinnon, Chairman and CEO, Bennett Jones

I. Introduction

The Legacy of 2020: A Catalyst for the Transformation of the Economy

Highlights

The year 2020 was a watershed: the most severe pandemic since 1918, and the worst economic crisis since the Great Depression. The starting point for planning for 2021 and beyond is thus strikingly different from one year ago. A new U.S. administration is an added factor of change.

Importantly, developments in 2020 have accelerated or exacerbated trends already taking place pre-pandemic, including the shift of economic weight to Asia, the digital transformation of the economy, and the rising attention worldwide to climate change.

Looking to 2021 and beyond, businesses have no choice but to re-think impacts for their markets, their workers, their supply chains, their communities. They must set new directions and in many cases embark on transformative initiatives—a strategic reboot.

For their part, while continuing to aid workers and firms through the crisis, governments must establish a climate that will encourage investment and contribute to improving the productivity of the economy. This should include credible fiscal anchors, and shifting fiscal action from supporting consumption to investing in productive capacity.

Strengthening our ability to trade, improving the skills of our workforce, investing in productive infrastructure, streamlining regulation, and accelerating digital transformation require priority attention. A key goal is helping our firms grow their market share, particularly in the world's fastest-growing economies.

The strategic reboot of firms, governments and the economy will require strong leadership, and collaboration between the public and private sectors. It must begin while we still find our way out of the crisis.

The year 2020 will be remembered in economic history as a watershed. The worst pandemic since the 1918 Spanish flu quickly led to the most severe economic crisis since the Great Depression. The arsenal deployed by central banks and governments worldwide has surpassed in scope, scale and speed any ever mobilized for an economic recession. The measures moderated the impacts of the crisis, and contributed to a reasonably strong, early bounce back of activity and jobs. However, the second wave of the pandemic is now in full force in many countries and regions. The crisis is not over, and its aftershocks will be long lasting. Some sectors and regions, some segments of the labour market, and some parts of the population have been disproportionately hurt.

As we turn the chapter on 2020, there is hope of better times ahead, with rapid progress in the development of at least three highly promising vaccines. If the vaccines, once approved, are available quickly, and if—a big "if"—the logistical challenges of distribution can be overcome, this will provide a foundation for stronger confidence and recovery.

Concurrently, the results of the U.S. elections create prospects of a return to some normalcy in global affairs and trade. For sure, the United States will continue to advance its own interests, not always aligned with Canada's. President Biden's commitments to rescind the permit for the Keystone XL pipeline and to pursue Buy America policies make this clear. However, Canada and other nations will find it easier to know where the U.S. administration stands, and where and how there may be collaboration and solutions. It will be the job of our governments to defend vigorously Canada's interests while keeping an eye on the bigger picture of the bilateral relationship.

The Starting Point for 2021: What a Difference a Year Makes

Thus, the starting point for this Economic Outlook is strikingly different from only one year ago.

- **Global output at the end of 2020 is some 4.4% below one year earlier.**[1] While the economy in Canada has recovered about three quarters of the output, employment, and hours worked lost in the precipitous fall of the second quarter, the momentum of recovery in Canada, and globally, slowed in the fourth quarter.
- **Global debt has spiked to historical highs.** The International Monetary Fund (IMF) estimates that given the strong fiscal response to the pandemic, sovereign debt to GDP in advanced economies will rise by 20 percentage points, to about 125% of GDP by the end of 2021. Businesses have also borrowed heavily to get through the crisis. Altogether, the Institute of International Finance estimates that total debt will reach 365% of global GDP by the end of the year, up sharply from 320% at the end of 2019.[2]
- **Financial conditions are supportive of the recovery, and in the short term facilitate the servicing of the higher debt.** The aggressive actions of central banks worldwide have resulted in lower interest rates for both short-term and longer-term debt. It has also supported global equity markets, further buoyed recently by the promises of vaccines and the improved prospects of recovery. In the United States, Canada, and Asia, equity indices are measurably above where they were one year ago. In Europe, some are slightly behind last year. With global activity still considerably below potential, concerns over inflation and a sharp rise in interest rates are muted in the short term. The longer-term picture raises more questions.

- **While metal and agricultural commodities have largely recouped their losses, energy prices are well below pre-pandemic levels.** The International Energy Agency (IEA) estimates that the global demand for energy will be down 5% in 2020; for oil, the drop is 8% and for natural gas 3%.[3] The West Texas Intermediate (WTI) benchmark price is now in a range of $45 per barrel, up considerably from the trough of April where it briefly dipped below zero in the futures market, but still below the $60+ level of early 2020.

The Structural Trends: The Acceleration and Deepening of Change

Importantly, this new context has not altered profound structural trends that were already prominent in early 2020. If anything, it has accelerated change and amplified the pressure and the urgency for economic actors to take heed and to adapt.

Specifically, the following factors today require a response by both the private and the public sectors that can no longer be deferred, and that can no longer be timid or strictly incremental.

- **A shift of the center of gravity of the global economy to the Asia Pacific and the inexorable rise of China as a global superpower.** While China was the origin of the pandemic, it has succeeded better than Europe, North America or most other emerging economies at containing the spread and the impact of the virus. As a result, China is expected by the Organisation for Economic Co-operation and Development (OECD) to contribute more than one third of global economic growth in 2021.[4] By the end of 2022, estimates suggest that China will have grown 16% above its end-2019 level, whereas that number will be less than 2% for the United States, Canada, Europe, and Japan. There are no known precedents for this rapid and this significant a shift in economic power globally.
- **Geo-political forces shaped by the strategic rivalry between the United States and China.** The pursuit of economic prosperity and national security are intertwined and they play out in the management by the two superpowers of geo-political forces. A key economic risk is the decoupling of global supply chains, including a splintering of the digital environment, into two (Chinese and American) spheres of influence. The more predictable and constructive tone of the Biden administration, that will also reach out to like-minded countries like Canada, may assist in safeguarding the global trade system in fostering improved collaboration on global and regional issues. However, the strategic rivalry with China will not abate.
- **The transformative effects of technology—everything from 5G, to robotics, to AI—across all sectors, markets and aspects of daily life.** The pandemic has injected steroids into this structural transformation of the economy. As anecdotal but powerful evidence, Amazon is reported to have hired 427,300 new workers in the first 10 months of 2020, a 50% hike in its workforce.[5] Work moved from offices to homes, and many workers now state a preference to working at least part of their time from home when the pandemic ends. The impacts on the labour market and on skills required for employment will be pervasive.
- **Demographic pressures that single out productivity as the most critical avenue to preserve and to raise standards of living.** There are opportunities, particularly in the short term, to re-establish and to raise rates of participation in the labour force. This will be an important policy preoccupation, for example ensuring that improved daycare services facilitate the participation of women. For Canada, restoring immigration to its pre-pandemic levels or greater will also help grow the labour force, including with highly-skilled workers. However, with

an aging population, there is no way around growing productivity to generate growth. That means leveraging technology and innovating across all sectors of the economy.

- **A trendline of widening inequality of income and economic opportunity.** Pre-COVID, rising inequality was already a source of policy preoccupation in advanced economies. Its manifestations were not only economic, they were socio-political, fueling challenges to traditional political institutions and exacerbating social conflict, such as racial tension in the United States. The disproportionate impacts of the pandemic on low-income wage earners and other vulnerable workers, which will not be reversed quickly, aggravate the problem. An improved safety net will be a necessary part of the policy response, but since the best income security is a well-paying job, inclusion and skills development are paramount.
- **The manifestations of a changing climate and the stated determination of countries around the world to transform the energy system and to shift to a low carbon or net-zero emissions economy.** The International Energy Agency (IEA) is clear that it is still too early to foresee a rapid decline in oil demand, and there are still robust prospects globally for natural gas to displace coal. For Canada, it must be a priority to get our resources to markets and to monetize the value of assets we have in the ground and our knowledge in extracting them responsibly. The writing nonetheless is on the wall that global energy systems are undergoing a transformation that favours more efficient energy use, renewable energy, and other technologies that will cut emissions. The Biden administration is strongly committed to step up U.S. action on climate change, at home and in its international engagement. It will expect Canada to be a strong partner.
- **The rising expectation of investors and the public for corporate engagement on environmental, social and governance (ESG) indicators.** The doctrine of Milton Friedman that the sole social responsibility of business is to increase its profits is now widely discounted. While opinion is still mixed on what is called "stakeholder capitalism", there is broad acceptance that a broader approach to corporate strategy has compelling merit. In a study that looked at large- and mid-cap U.S. publicly-listed companies from 2001-15, the McKinsey Global Institute found that companies with strong ESG norms recorded better top-line growth, lower costs, fewer legal and regulatory interventions, higher productivity, and better asset utilization.[6] In Canada, in particular in the resource sector, ESG pursuits include partnerships with Indigenous communities and contributions to their economic and social development.
- **The crowding out in the public sphere of facts and analysis by misinformation, ideology, and beliefs.** The ease and rapidity of mass communication through digital media has both enormous potential to create value, and proven capacity to be destructive and to erode the social contract that underpins good governance. Strong public and private sector leadership are required to understand underlying trends and make the necessary adjustments, while maintaining steady hands in the face of obstruction and noise.

The Perspective of Businesses: Going Back to the Drawing Board

The COVID crisis has tested, and continues to test, the resilience of firms, workers, and the economy.

As the economy still works its way through the pandemic, businesses have to take stock and operate a strategic reboot. Every organization has to assess the impacts of the COVID crisis that may be lasting, and the longer-term developments affecting its markets, the workforce, its supply chains, and its communities. The economy post-COVID will be different. Businesses have to think through and plan for a new normal.

Because developments in 2020 will have had differential impacts across sectors and firms, it is from different starting points, with distinct sets of circumstances, that businesses must set future directions and in many cases embark on transformative initiatives.

- **Trade-exposed businesses** have to re-assess their capacity to access global and regional markets, to capture market share where demand is growing, and to find their fit in supply chains that are adjusting to an evolving world.
- Despite the tensions with China, the **commodity sector**, in particular, must pursue as a matter of priority its expansion of markets in the Asia Pacific, while also identifying opportunities to innovate, add value, and secure greater value from Canada's resource base.
- The **oil and gas sector** confronts depressed demand and low prices at the same time as the pressure to accelerate a transformation toward a low-carbon energy system. Consolidation and innovation, including such technologies as hydrogen or carbon capture, utilization, and storage, will be key ingredients of the journey.
- The **manufacturing sector** also must find its place in moving supply chains, particularly as it develops and embeds in its processes and its products the new technology that will shape competitive advantage.
- For example, Canada's **automobile and parts sector** has to engineer a transformation to participate in the North American and global supply chains for electric, automated vehicles that are destined to dominate the market.
- Parts of the services sector like **tourism, hospitality and passenger transportation** that are still reeling from the COVID crisis will not survive. Existing and new businesses that will emerge from the crisis will need to first ensure worker and consumer safety, and adjust to new ways of doing business.
- The **financial sector** must be attuned to an economy ever more driven by digital innovation, including for payments. The prospect of a central bank issued digital currency, while still some ways off, has ramifications that require early and careful assessment by both the private and public sectors.
- The **information management and information technology sector**, from start-ups to large firms, have to situate their development in a universe where data and information infrastructure will determine the competitive advantage and national security of economies. The risk of policy and regulatory divergence, notably between the United States, Europe and Canada, not to mention China, complicate considerably strategic planning.

In sum, no business can afford a *status quo* strategy.

The Macro Perspective: Creating the Conditions for Investment in Productive Capacity and Innovation

At a macro level, the expression of the challenge faced by our businesses is for Canada to succeed in selling goods and services that the world wants to buy today, and those that it will want to buy tomorrow. Stronger investment and trade will make a critical contribution to supporting confidence in the dollar, sustaining low inflation and low interest rates, and managing the public and private debt accumulated through the crisis.

Thus, it must be a priority of governments to establish a climate that will encourage investment in infrastructure, productive capital, skills, and innovation necessary for our firms to grow their global market share, particularly in the world's fastest-growing economies. On the trade policy side, Canada starts with some advantages: a renewed agreement with the United States, and new ones with parts of the Asia Pacific, and with the European Union. What matters now is equipping ourselves to take advantage of these agreements. Sooner or later, there must also be some framework for our businesses to trade with China with greater confidence. The market is too large to ignore. Indeed our exports there in 2020 have performed better than in other markets. Our institutional investors—e.g., our pension funds—are also heavily invested in this rapidly-growing economy. A new U.S. administration and multilateral collaboration may assist in improving the bilateral relationship.

A cornerstone of economic management remains a sound macroeconomic framework, including the renewal of the inflation targeting regime with the Bank of Canada, and the establishment of credible fiscal anchors to ensure the sustainability of public finances. It was, and it continues to be, appropriate for monetary and fiscal policy to act aggressively through the pandemic to aid workers, families and businesses. Governments cannot pull back too quickly, particularly for vulnerable workers and families. The economic crisis will be deeper, and its impacts longer term, if incomes and activity are not adequately supported on the way to recovery. However, the low interest rates that today allow governments to service a rising level of public debt will not be everlasting. Recognizing uncertainty and risk, the direction must be set firmly now for lower fiscal deficits.

Since we cannot share what we do not produce, fiscal action must shift gradually from supporting consumption to enabling investment in productive capacity. The programs of aid to workers and businesses introduced by the federal government through the crisis, with some hits and misses, have targeted principally short-term relief. Going forward, more of the effort must facilitate adjustment and generate a longer-term economic return.

The Challenge for Government: Focus, Design, and Delivery

Indeed, it is not only *how much* government is spending that matters but also *how* it is spending and intervening in the economy. As large organizations, governments have a massive impact on productivity. They too must take stock of the new environment, and transform not only their policies, but their ways of doing.

Governments succeed best when they have a focused agenda and when they pay consistent attention to the design and delivery of policy and programs. Overcrowded agendas will be poorly executed and they will weigh the economy down. Design and delivery have to be aligned with new economic realities and with technology. While problems such as the pandemic require urgent short-term action, there must be careful deliberation before introducing more permanent large-scale programs. For example, if the crisis has shown that the policy and administration of the Employment Insurance system were not up to the task of responding to a large shock in the labour market, none of the new programs provide the blueprint for a reform of the income safety net. There will need to be dedicated work and this economic outlook proposes an independent commission to review and advise on the manner.

Opportunities to improve measurably the contribution of policy to the productivity of the economy require strong collaboration between the public and the private sectors. For example:

- Investment in physical or digital **infrastructure** can be pursued with strong private sector participation, and with lesser public borrowing, not simply to create construction jobs today, but to generate long-term public and private returns.
- **Regulation** can be streamlined and modernized to facilitate and promote innovation, and to allow businesses to meet high regulatory standards while competing more effectively in domestic and global markets. We cannot regulate the economy of the 2020s with 1960s-style standards and processes.
- Government can improve services to their citizens by accelerating its **digital transformation**, leveraging the power of data for the public good, and helping to create the infrastructure—for example a system of digital ID—that can make our economy more productive and more competitive.

The Strategic Reboot: Putting the Wheels in Motion

Strategic reboots do not just happen. They follow a deliberate process inspired by strong leadership. This is true for individual firms. It is true in government. It is true for the economy.

As we struggle through the pandemic and look beyond, the time is right for a strategic reboot.

This economic outlook offers elements of context: macroeconomic scenarios and planning assumptions for the next two years, a commentary on fiscal policy, a survey of the geo-political and trade environment, a review of developments in labour markets and challenges ahead, and a critical examination of delivery in government.

II. The Global and Canadian Economies

Recent Developments and Projections to 2022

Highlights

The outlook for the global economy remains highly uncertain. Developments over the next two years will depend critically not only on the availability of vaccines for COVID-19, but on the timeliness of their distribution, their effectiveness in the field, the response of individuals and businesses, and the ability and willingness of governments to continue to provide fiscal support.

Businesses and governments nonetheless need assumptions and scenarios to plan.

Under a baseline scenario for the global economy:

- after a precipitous drop in output in 2020, advanced economies grow modestly in the first quarter of 2021, shift into higher gear until mid-2022, and then slow down on the way to what are now reduced rates of potential growth;
- for example, after a drop of output of 3.6% in 2020, the U.S. economy grows by 3.6% in 2021, and 3.3% in 2022;
- China ends the year 2020 with a gain of output of 2% and then takes off again to grow at rates of 8.1% in 2021, and 5.6% in 2022—by the end of 2022, it will have grown by 16% relative to the end of 2019, compared with less than 2% for advanced economies;
- there is wide variation in other emerging economies and many risks and uncertainties ahead—for example, output in India will contract by about 10% in 2020, and the road to recovery is uneasy.

For Canada, under this baseline scenario:

- output in the fourth quarter of 2020 will be 4.9% below a year earlier; it will grow by about 3.9% during 2021 and 2.7% during 2022;
- employment will tend to recover in step with output, but it will also be affected by the sectoral composition of growth, and by changes in productivity.

The pandemic will have lasting impacts on the economy. It is not merely lowering potential output. It is bringing about and accelerating structural change that will entail both a reallocation of capital and labour across industries, and a change in the mix of capital and labour skills within industries.

Monetary and fiscal stimulus are appropriate in the current circumstances. It will also be important coming out of the pandemic for policy to facilitate adjustment to the structural change.

The Global Economy: Recent Developments

While one year ago we looked forward to modest, sustained global growth in 2020 and subsequent years, the COVID-19 pandemic, and the lockdowns imposed globally, upended this scenario. The global economy was on track to grow at rates in the vicinity of an estimated potential of slightly over 3%, with the United States and Canada growing at about 2%, Europe at about 1.5%, and China at close to 6%. Starting in January in China, and March–April in much of the rest of the world, output plummeted before rebounding sharply—if only partially—when social distancing measures eased. In China, the rebound occurred in the second quarter, and in the advanced economies in the third quarter. By the third quarter, output levels were still sharply lower than in the final quarter of 2019, by 3.5% in the United States, 4.4% in the euro area, and 4.2% in Japan. In China, however, real GDP was up 3.2% by the third quarter.

The drop in activity in advanced economies has been concentrated in the services sector. For travel, accommodation, entertainment and food services, the collapse in demand sharply curtailed output, employment and prices. Across the services sector, GDP and jobs in September remained well below February 2020 levels. For manufacturing, the expansion of aggregate demand and production in China, however, contributed to a stronger rebound of activity.

As a result of depressed global demand and high unemployment, headline inflation has declined everywhere. The prices of commodities also reflected the sharp fluctuations of activity. The price of oil (West Texas Intermediate benchmark, or WTI) plummeted well below $20 per barrel in April, even dipping temporarily below zero in futures markets, before recovering to about $40 by July, with more recent modest gains since then, pushing it to about $45, still much lower than at the beginning of 2020.

Monetary and fiscal authorities combined their efforts in the early months of the pandemic to support domestic income and demand.

Central banks used all of the tools in their arsenal. They reduced their policy rate to near zero or kept them into negative territory (e.g., the case of the European Central Bank), introduced or expanded quantitative easing, and created facilities to support the functioning of financial markets and continued access to financing for businesses.

Correspondingly, and aided further by new policy signals from the Federal Reserve, market interest rates, short and long, fell to exceptionally low levels. The U.S. 10-year bond yield declined from about 1.6% in the first half of February to less than 0.7% by April. Expectations that interest rates will be kept at exceptionally low levels for many years to come were reinforced in August when the Federal Reserve announced a new strategy for monetary policy. Called "average inflation targeting", this policy will be more tolerant of temporary increases in inflation beyond the 2% target. The idea is to compensate for persistently low inflation in the past, and to allow employment to run at, or above, estimates of its maximum level.

By helping to keep long-term interest rates low, quantitative easing enhanced, or at least preserved, the stimulative impact of fiscal measures. In the United States, the Federal Reserve increased its balance sheet from US$4.2 trillion in February to US$7.0 trillion in August, where it has largely remained. The absorption by central banks of a significant portion of the net government borrowing undertaken to finance the response to the COVID crisis induced lower longer-term interest rates than would otherwise have been set by markets.

Fiscal authorities worldwide launched unprecedently large programs to support health systems and provide lifelines to vulnerable households and firms. In October, the IMF estimated that new fiscal measures announced globally by early September amounted to US$11.7 trillion, or close to 12% of global GDP. One half of this amount consisted of additional health care spending, cash transfers, wage subsidies, furlough schemes, and temporary enhanced welfare benefits and tax deferrals. The rest represented contingent liabilities in the form of loans or guarantees. In the United States, as employment plummeted, rapid and large one-time payments to households under the Coronavirus Aid, Relief, and Economic Security (CARES) Act passed by Congress in March in fact caused real household disposable income in the second quarter to exceed by 10% its level of the fourth quarter of 2019. U.S. disposable income, predictably, fell in the third quarter absent a new inflow of emergency transfers. Only a portion of the increase in disposable income created effective demand, however. The personal saving rate shot up to 26% in the second quarter, before retreating to a still high 16% in the third.

The U.S. dollar, overall, weakened through the year. It experienced a sharp temporary multilateral appreciation in March as global demand for safe assets flared up. This was followed by a more gradual, but steady, depreciation from May onwards. Compared with February 2020, the U.S. dollar has depreciated relative to the euro, the yen and the yuan by 8%, 5%, and 5.6%, respectively.

The recovery lost momentum in the fourth quarter. A second wave of the pandemic hit many advanced economies toward the end of the summer months, and this fall new cases of coronavirus are breaking record levels. Along with some depletion of pent-up demand, the resulting tighter restrictions and increased uncertainty have slowed the recovery. This is shown by high-frequency economic indicators, such as employment, retail sales, purchasing manager index, and industrial production. In the euro area, with new lockdowns imposed at the end of October in France, Germany and other countries, the economy will likely shrink significantly in the fourth quarter.

The Global Economic Outlook to 2022

Growth prospects for 2021 brightened in November with news that highly effective vaccines were on their way and could be approved for production before the end of 2020. Indeed, there has been early, positive market reaction. Equity markets have been bolstered. Oil prices have edged higher. The 10-year Treasury yield is also up modestly.

Nonetheless, the evolution of the pandemic in 2021, and its effect on the global economy, remain uncertain, depending not only on availability of vaccines but on many other factors. Critical variables include: (1) the willingness of citizens to abide by social distancing and restriction of activities, particularly as periods of confinement are extended through the winter; (2) the timeliness of the distribution of the vaccines and their effectiveness in the field; (3) the confidence of the population in the vaccines, their participation in the campaigns of inoculation, and their economic behaviour if and once vaccinated; (4) the willingness of governments to borrow to provide support to the economy.

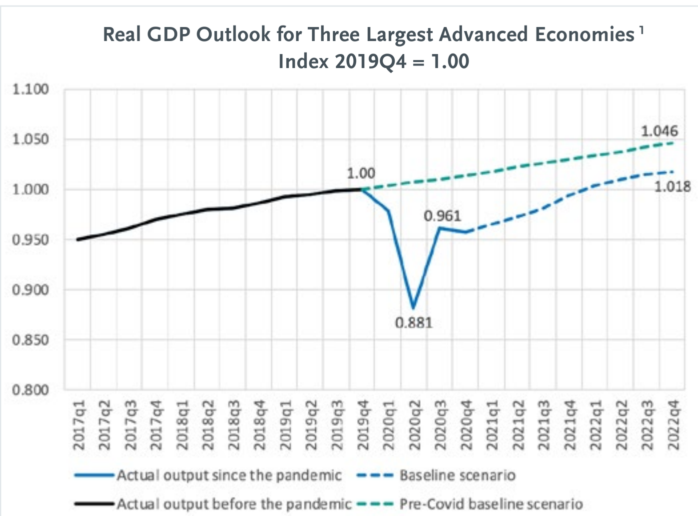
However uncertain the future, we need a baseline scenario to guide planning by businesses and policy decisions by governments.

Assumptions

In our baseline scenario for the advanced economies, we take it for granted that highly effective two-dose vaccines will be approved by the end of 2020. Vaccination will start in the first quarter of 2021, with a small tranche of population being inoculated, but will gather momentum in subsequent quarters as more vaccines become available. The pace of vaccination over time will vary considerably across countries, but we assume that for all practical purposes vaccination will be completed by mid-2022. Meanwhile, with few exceptions, the current wave of the virus will not trigger lockdowns as tight and extensive as in March–April this year, but will be contained by continuing social distancing, restrictions on the size of gatherings, intensified testing and tracing, and more localized intervention.

On this basis, we project that after nearly a pause in the final quarter of 2020, and modest advance in the first quarter of 2021, the recovery in advanced economies will shift into higher gear until mid-2022, before easing on the way to lower rates of potential growth (Chart 1).

Chart 1



[1]United States, euro area, and Japan

We expect policy interest rates to remain at their current zero or negative levels over the period to the end of 2022, and emergency fiscal measures to continue but to be tapered through 2021. We expect the phase-out of large-scale emergency programs to be partly compensated by temporary programs that will facilitate structural adjustment while preventing a brutal fiscal retrenchment from derailing the recovery.

Fiscal deficits in the advanced economies will come down gradually from exceptionally high levels in 2020. The IMF has projected paths of general government deficits as a percentage of GDP that are consistent with their estimates of the announced emergency support measures and their projections of real GDP to 2025 (Table 1). Fiscal deficits shrink by over one half in 2021, and by 2022 they are nearly at the same level as in 2019. This seems optimistic but the downward trend is likely to hold true. Under the IMF scenario, the gross debt ratios that have shot up in 2020 plateau at that level to 2025. This, again, may be on the optimistic side.

Table 1

IMF PROJECTIONS OF GENERAL GOVERNMENT DEFICITS AND DEBT AS % OF GDP

	2019	2020	2021	2022
United States				
Fiscal Balance	-6.3	-18.7	-8.7	-6.5
Debt	108.7	131.2	133.6	134.5
Euro Area				
Fiscal Balance	-0.6	-10.1	-5.0	-2.7
Debt	84.0	101.1	100.0	98.4
Japan				
Fiscal Balance	-3.3	-14.2	-6.4	-3.2
Debt	238.0	266.2	264.0	263.0
Advanced Economies				
Fiscal Balance	-3.3	-14.4	-6.9	-4.6
Debt	105.3	125.5	125.6	125.6

Source: IMF, *Fiscal Monitor*, October 2020.

The projected pick-up in global demand will support commodity prices. Oil prices (WTI) are expected to evolve in a range of $40–$55 per barrel in the next two years. Metals prices should continue to increase in the short term, but at a more moderate pace than during the second half of 2020, mostly aided by robust demand from China.

The pandemic is likely to have a negative effect on potential output in the global economy. Trend hours worked and trend labour productivity may be pulled down by a number of factors: a loss of productive capital through bankruptcies, weaker investment, lower labour force participation, higher structural unemployment, and obstacles or frictions in the reallocation of labour and capital to higher-growth industries. What the path of potential output will be is difficult to ascertain with confidence. The Bank of Canada developed some estimates that suggest a level of potential output in the United States 1.6% lower in 2021 and 2022 than pre-COVID projections.

Despite the recovery of aggregate demand that we project, and despite the lower level of potential output, advanced economies will experience excess supply through to 2022, keeping inflation below, or at most at, target. Inflation may increase gradually in the short term. Firms may incur higher costs to implement public health measures in the workplace, or to increase the resilience of their supply chains. There may be shortages in specific markets. However, these factors will recede and inflation should stay low, even in the United States, especially if digital transformation and other innovations continue to pull down unit labour costs.

Thus, we assume that policy interest rates remain unchanged, although longer-term interest rates may be pushed up by rising inflation expectations in financial markets.

Baseline Scenario

In our baseline scenario, world output drops 4.2% in 2020, before rebounding by 5.1% in 2021, and 4.3% in 2022 (Table 2).

For the advanced economies, the drop in 2020 is more pronounced, at 5.3%, and the recovery is slower, at 3.8% in 2021 and 3.3% in 2022. Output in the three largest advanced economies, i.e., the United States, the euro area, and Japan, would fully regain its end-2019 level only by the first quarter of 2022. By the end of 2022, it would still be below pre-COVID projections by about 2.7%. Other advanced economies would follow a similar path.

The U.S. economy is projected to contract by 3.6% in 2020, before growing by 3.6% in 2021 and 3.3% in 2022. The drop in activity in 2020 is shallower than in other advanced economies on average because of the lesser restrictions to stem the contagion, and the larger fiscal and monetary stimuli. The economy is expected to grow modestly in the fourth quarter of 2020 and in early 2021 as the spread of COVID reaches unprecedented intensity at the same time as emergency economic support is phased out. With a robust showing of Republicans in the Congress, we assume that the Biden administration will be constrained to bring only a modest fiscal stimulus in 2021, in the order of $1 trillion compared with the $2.2 trillion advocated earlier by the Democratic Party. Nonetheless, along with the launches of vaccines, this fiscal package would help to accelerate the recovery by strengthening activity, income and confidence. Households will be more willing to draw down savings, or at least reduce their relatively high precautionary saving rate, in order to increase spending. In turn, stronger household spending, and improved confidence, will stimulate business investment. As slack in the economy diminishes, growth during 2022 would slow towards its potential rate, now estimated to be around 1.5%.

Table 2

SHORT-TERM PROSPECTS FOR OUTPUT GROWTH (%)

	Share of World Output (%)[1]						% Change
	2019	2018	2019	2020	2021	2022	2022Q4/2019Q4
Canada	1.4	2.4	1.9	-5.7	3.6	3.7	1.5
United States	15.9	3.0	2.2	-3.6	3.6	3.3	3.0
Euro Area	12.5	1.8	1.3	-7.2	3.8	4.0	0.6
Japan	4.1	0.3	0.7	-5.4	2.7	2.2	0.7
Other Advanced Economies	9.2	2.4	1.7	-5.7	4.4	3.1	
China	17.4	6.8	6.1	2.0	8.1	5.6	16.0
India	7.1	6.1	4.2	-10.3	8.8	8.0	
Other Emerging & Developing Economies	32.4	2.9	2.3	-4.8	4.5	4.0	
World	100	3.5	2.8	-4.2	5.1	4.3	

[1] Shares of world output are on a purchasing-power-parity basis. Source: IMF, *World Economic Outlook*, October 2020.

In the euro area, GDP is projected to drop by 7.2%, before growing by 3.8% in 2021 and 4.0% in 2022. The contraction of activity in the first half of 2020 was more severe than elsewhere but its rebound in the third quarter was more vigorous. Real GDP is expected to decline in the fourth quarter as governments introduce more severe restrictions to stem a galloping COVID infection. As in the United States, renewed fiscal support, the launches of vaccines and reduced uncertainty would boost growth in 2021, especially in the second half of the year. During 2022 growth would slow towards its potential rate of a little over 1%.

China is projected to grow by 2% in 2020, 8.1% in 2021, and 5.6% in 2022, much faster than any other economy after 2019. Fiscal support has aided an industrial expansion underpinned by solid gains in exports, especially of medical equipment and electronic products, and robust investment in infrastructure and real estate. This has led to a pick-up in demand for commodities. As the expansion continues, household consumption and private investment will make a more important contribution to growth, while the projected recovery in global activity will support yet stronger export growth.

The rapid economic growth of China makes a strong economic case, in a period of recovery, for other economies to integrate their domestic production with China's supply chains through expanded trade and investment. Tighter economic linkages will be supportive of growth, including through innovation and economies of scale. Indeed, China's lead in the share of world output is set to increase further this year, and in the years to come. From the end of 2019 to the end of 2022, China is projected to grow by 16%, whereas advanced economies would advance by less than 2% on average. Moreover, China is at the vanguard of new technologies and products for which fast-growing markets are to be expected in the medium term (e.g., electric vehicles).

There is wide variation, and greater uncertainty, in projections for other emerging and developing economies. In stark contrast to China, India will experience a loss of output of some 10% in 2020. GDP in the other emerging economies is projected to drop by an average of 4.8%. The IMF expects emerging economies to recover in 2021 and 2022, aided by stronger global demand and gains in the prices of oil and metals. However, their recovery is precarious because of constraints in the capacity of their governments to contain the virus, sub-par health systems, dependence on tourism and remittances, and lesser capacity for fiscal support.

ECONOMIC RESTRUCTURING

Economies will undergo structural adjustment as changes in business practises and household preferences resulting from the pandemic are likely to prove persistent. Factors such as the increased reliance on online shopping and remote working, increased use of technology that reduces personal contact in health care and education, a move towards more resilience of supply chains, and downsizing in the travel and tourism sector, will affect the mix of products, services, skills and technologies in the post-pandemic economy. Federal Reserve Chair Jerome Powell has observed that economies will become "more reliant on technology and automation, which would disproportionately hit lower-paid workers in the service sector."[7]

Restructuring will entail both a reallocation of capital and labour *across* industries, and a change in the mix of capital and labour skills *within* industries. Such change takes place all the time to some degree, but no doubt the pandemic will amplify and accelerate it. The change brings with it costs of adjustment. In some industries with specialized capital, for example air transportation, a significant share of assets may be scrapped prematurely. In some of the most affected sectors, there may also be waved of bankruptcies among small businesses. Human capital will be eroded as some firms and industries downsize and jobs are lost permanently. A degree of skills mismatch in the labour market is also to be expected, pushing up the structural rate of unemployment, especially if geographic mobility is limited.

The cost of the restructuring that will be incurred to reset the economy to its former growth potential, and then to increase it, is highly uncertain. Governments have a critical role to play in facilitating the required adjustment, notably by creating the conditions for investment that will allow the upgrading and efficient reallocation of capital and labour.

Risks

There are both upside and downside risks to our baseline scenario for the global economy. Widespread vaccination in the first quarter of 2021 would accelerate the recovery relative to the baseline scenario. On the other hand, vaccines may turn out to be less effective in the field than expected from trials, or their availability more restrained than assumed. A larger than expected tranche of the population may refuse to take the vaccine, or the inoculated population may be more risk averse in its activity and spending than anticipated. In these cases, the recovery would be more protracted. Debt overhangs coming out of the pandemic make economies more vulnerable to these downside risks.

A downside risk to our baseline scenario is that many countries repeat the error made in the early 2010s of imposing premature austerity in order to contain or reduce debts built up during the recession. The fiscal tightening just coming out of the Great Recession slowed the pace of a nascent recovery, kept unemployment higher for longer, and in the end made it more difficult to achieve budgetary targets. While fiscal consolidation will have to be pursued to set public finances on a sustainable track in the wake of the pandemic, the timing and amount of retrenchment must be calibrated according to how speedy and sustained the recovery in aggregate private demand proves to be. Imposing austerity before the economy operates at, or close to, capacity risks slowing the recovery unduly, especially since there is little scope for more stimulus from monetary policy to offset the resulting fiscal drag.

The Canadian Economy: Recent Developments

After a precipitous drop of output in the early onset of the pandemic, the Canadian economy bounced back sharply. With the gradual reopening of the economy that started in May, real GDP in the third quarter surged 40.5% at an annual rate, with the largest contributions coming from exports of goods (a contribution of 18 percentage points (p.p.)), household consumption of durable goods (11.2 p.p.), services (13 p.p.), and housing (10.3 p.p.). This was partly offset by a surge in imports of goods (-26.1 p.p.). At play were a rebound in foreign activity, the release of pent-up demand for durable goods and housing, and the support to income and spending provided by expansionary fiscal and monetary measures. The resurgence of activity in the third quarter gave rise to sharp rebounds in both employment (39.2%), especially part-time, and hours per job (21.7%). The Canadian dollar appreciated by 6% between June and September, reflecting the multilateral depreciation of the U.S. dollar and a partial recovery of oil prices.

In aggregate, by September, both real GDP, employment and hours worked had recuperated about three quarters of their losses from the pandemic. This economy-wide average, however, masks large variations across industries (Chart 2). In retail trade, real estate, rental and leasing, and finance and insurance, real GDP in September exceeded the pre-pandemic, February level. On the other hand, in entertainment and recreation, accommodation and food services, transportation, and mining and oil and gas, it remained, to varying degrees, well below February levels. The employment numbers broadly reflect the same variations across industries.

Chart 2[8]

	FEBRUARY 2020 SHARE OF ECONOMY	
	Real GDP	Employment
Mining and Oil & Gas Extraction	8.8	1.2
Oil & Gas Extraction	6.1	0.3
Construction	8.1	6.3
Manufacturing	10.8	9.3
Wholesale Trade	5.8	4.9
Retail Trade	5.5	12.1
Transportation & Warehousing	4.9	4.7
Air Transportation	0.5	0.5
Information & Cultural Industries	3.7	2.1
Finance & Insurance	7.8	4.5

VARIATION SINCE FEBRUARY 2020

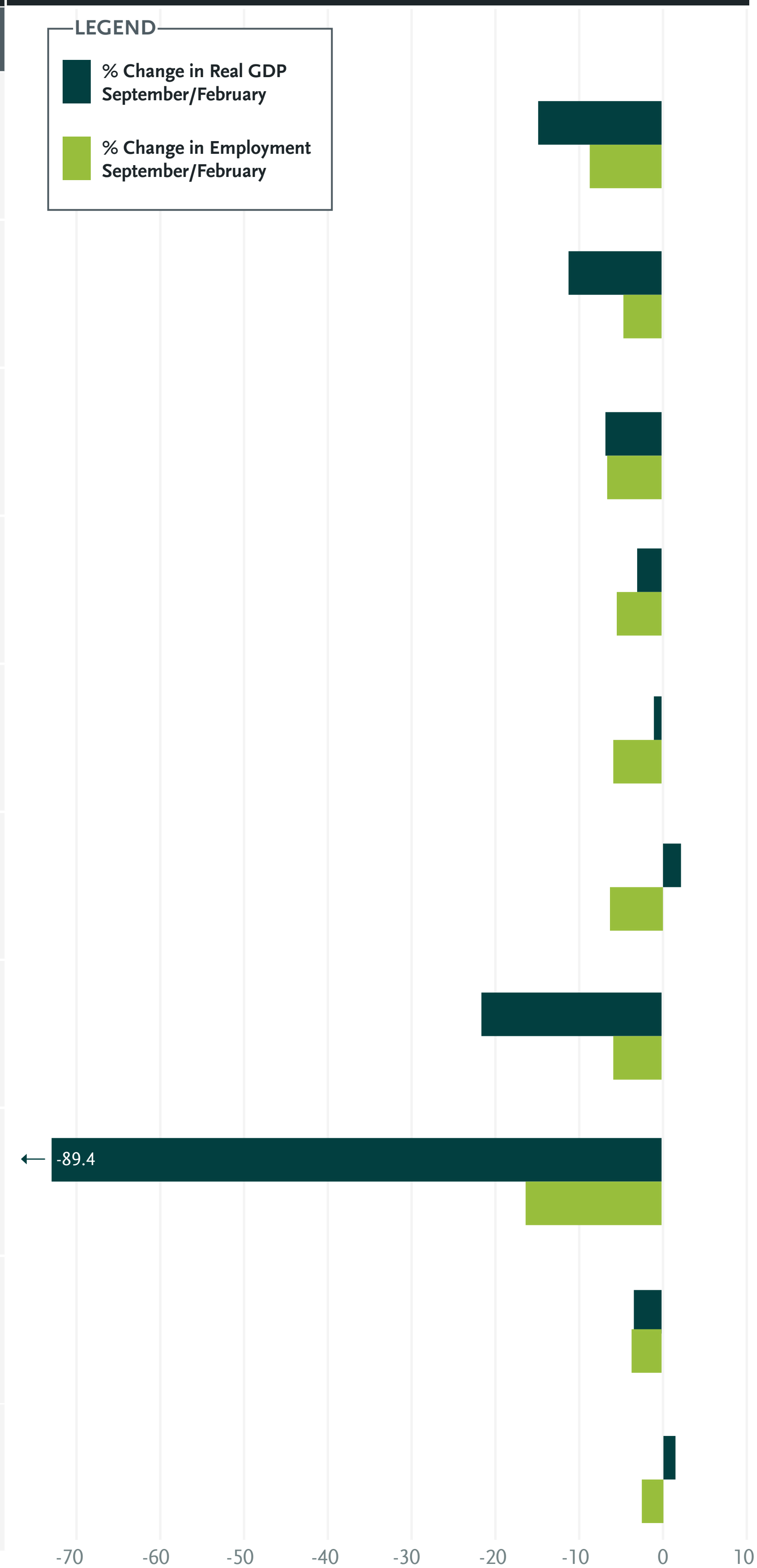
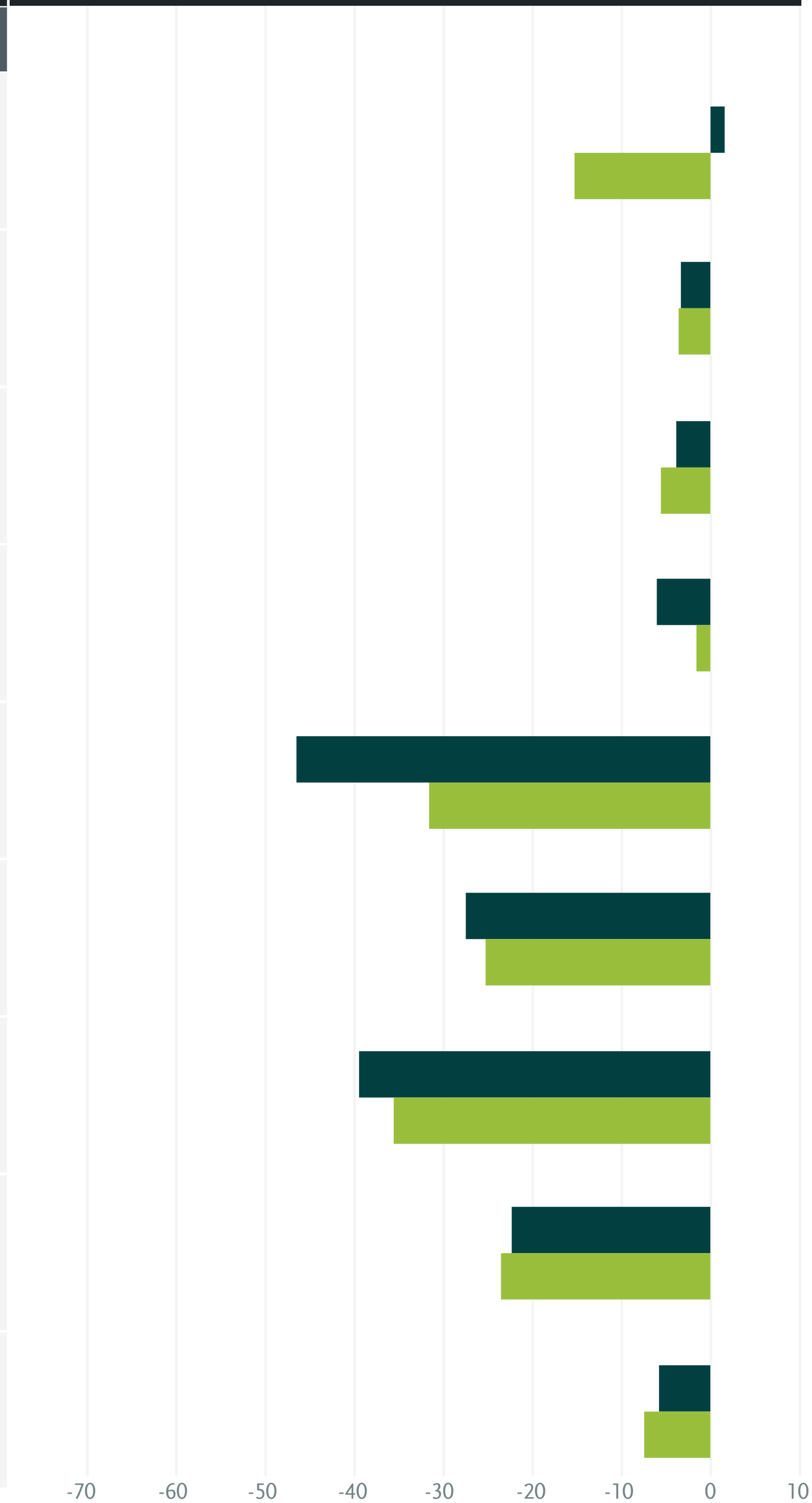


Chart 2

	FEBRUARY 2020 SHARE OF ECONOMY	
	Real GDP	Employment
Real Estate, Rental & Leasing	5.2	1.7
Professional, Scientific & Technical	6.8	5.9
Educational Services	5.8	8.2
Health Care & Social Assistance	7.8	12.3
Arts, Entertainment & Recreation	0.9	1.9
Accommodation & Food Services	2.4	8.0
Accommodation Services	0.7	1.2
Food Services & Drinking Places	1.6	6.8
All Non-Farm Industries	100.0	100.0

VARIATION SINCE FEBRUARY 2020



Statistics Canada. Table 36-10-0434-01 Gross domestic product (GDP) at basic prices (at constant 2012 prices), by industry, monthly. https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=3610043401
Employment is taken from Survey of Employment, Payrolls and Hours (Statistics Canada Table 14-10-0220-01).

Like other central banks in the world, the Bank of Canada responded to the pandemic quickly and forcefully. In March, it cut its policy rate from 1.50% to 0.25%, and it launched several asset purchase programs which expanded its balance sheet by $400 billion after three months. Governor Tiff Macklem stated on October 28: "*we will continue to hold the policy interest rate at the effective lower bound until economic slack is absorbed so that the 2 percent inflation target is sustainably achieved. In our current projection, this takes us into 2023.*"[9] On that same date, the Bank indicated that it was shifting its asset purchases towards longer-term bonds, "*which have more direct influence on the borrowing rates that are most important for households and businesses.*"[10] As then Senior Deputy Governor, Carolyn Wilkins, said: "*the operational use of [asset purchase] programs will remain tied to the Bank's operational control objective.*"[11] This implies that the Bank will reduce its balance sheet in the future in order to drive up market interest rates if needed to choke off inflation. Partly as a result of large-scale asset purchases, the 10-year Canada bond yield fell to an all-time low of about 0.55% in late May. It has remained at about 0.7% since the summer while net asset purchases have edged down.

To bridge households and businesses until the economy reopens in earnest, the federal and provincial governments deployed one of the largest COVID-19 fiscal responses in the world. Using information up to mid-September, the IMF estimated new discretionary measures of spending and foregone revenue to amount to 12.5% of GDP in Canada, versus 9.3% in the advanced economies as a whole.[12] In its Fall Economic Statement, the federal government reports a commitment to date of $270 billion, or about 12.5% of GDP, in direct support to Canadian businesses, workers, and families.[13]

While economic lockdowns caused large losses in employment and hours worked, massive fiscal transfers to households more than compensated for the loss of income and brought household disposable income in the second quarter 13% on average above the pre-pandemic level. Disposable income declined in the third quarter, by 3% relative to the second quarter, as government transfers to households fell by 25%. The household saving rate, which had climbed from 5.9% in the first quarter to 27.5% in the second, retreated to 14.6% in the third.

Information available as of December 4 suggests a sharp slowdown of output in the fourth quarter. Employment growth slowed in October and again in November to 0.5% and 0.3%, respectively, compared with an average monthly growth rate of 2% during the third quarter. Likewise, hours per worker increased at a monthly rate of 0.6% so far in the fourth quarter, versus 1.4% during the third quarter. Moreover, the labour force participation rate retreated in November, after registering six monthly gains in a row. With more restrictions imposed by governments in December, employment and output could well decline in that month.

Headline Consumer Price Index inflation fell from 2.2% in February to 0.7% in October. This reflected a decline in energy prices together with a slight easing of core inflation from 1.9% in February to 1.8% in October. However, because the pandemic has led to changes in consumption patterns away from items like gasoline, airline tickets and hotel rooms, the prices of which have fallen, headline inflation recorded since March likely underestimates price increases actually experienced by consumers.

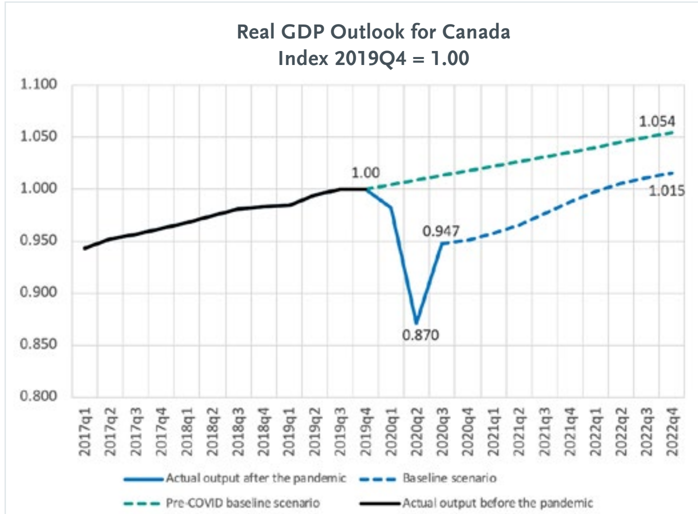
From September to November, the Canadian dollar remained in a 75-77 U.S. cents range.

The Canadian Outlook to 2022

As per our assumption for other advanced economies, we take it for granted that Health Canada will approve one or more highly effective, two-dose vaccines around the end of 2020. We assume that provincial authorities will facilitate wider distribution through 2021, and that widespread vaccination will practically eliminate the drag on economic activity exerted by the virus by mid-2022. But in the short term, especially during the coming winter months, restraint measures will continue to hold back activity and confidence. Indeed, we assume that while the current wave of the virus will not trigger a complete lockdown, it will continue to require localized restrictions and impose social distancing and restrictions on the size of gatherings.

On this basis we project that real GDP at the end of 2020 will be 4.9% below its level of a year earlier, and that it will bounce back by 3.9% during 2021 and 2.7% during 2022. The recovery will be subdued in the first half of 2021, but it will gather momentum in the second half as widespread vaccination boosts activity, confidence and spending. Growth would ease during the second half of 2022. In this scenario, output by the end of 2022 would still be some 3.5% below where it would have been under pre-COVID projections (Chart 3). Despite slower growth in potential output caused by the pandemic, there would likely be some slack remaining in the economy, and inflation would remain at, or below, 2% to the end of 2022.

Chart 3



The trajectory for employment will depend in part on the evolution of labour productivity. Our projection for real GDP accommodates several possible trajectories. Different factors are at play. The recovery of services industries, especially accommodation and food, entertainment and recreation, as restrictions are relaxed and confidence improves in 2021, should contribute to reasonably strong job growth. Altogether, one could see employment growth in a range of 2.8% during 2021 and 2.6% during 2022, with also a modest rise in the participation rate. The unemployment rate would fall below 7% by the end of 2022. One can also construct a scenario where there is greater investment in digitization and automation across the economy. This would push productivity up, at the expense of a slower growth of employment in the short term, about 2.2% per annum. The unemployment rate, while still on a descending trajectory, would then be about 7.3% by the end of 2022.

Several market forces are expected to hold back growth over the projection horizon. Uncertainty will continue to weigh on business investment, travel will not revive until at least early 2022, and low oil prices will still hold back investment in the oil and gas industry.

Importantly, fiscal policy will be a moderating factor. Based on budgetary parameters presented to date by the governments of Canada, Ontario, Quebéc and Alberta, shrinking deficits could represent negative impulses of some 11.5% of GDP in 2021-22, and 4.4% of GDP in 2022-23 (Table 3). The largest drag on the economy would originate from the federal budget.

We expect the effect on growth exerted by budgetary retrenchment and other factors to be counteracted by a fall in the household saving rate, gradual expansion of exports, and very low interest rates. Over the period, the overnight rate is projected to remain at its current level, and the rate on 10-year Canada bonds to increase only slowly from 0.7% at the end of 2020, to 1.6% at the end of 2022. On net, consumption, exports, housing, inventory investment and non-transfer government spending will all make significant contributions to growth. As aggregate demand strengthens and slack diminishes, business fixed investment will ramp up in 2022.

Table 3

FISCAL IMPULSE FROM BUDGETS

	2019-20	2020-21	2021-22	2022-23
Canada + Ontario + Quebéc + Alberta				
Deficit ($B)	60	475	237	145
Net Capital Investments ($B)	14	20	17	17
Net Borrowing ($B)	75	494	254	162
Net Borrowing as % of GDP	3.2	22.5	11.1	6.7
Net Fiscal Impulse % of GDP		19.3	-11.5	-4.4

Bennett Jones

Anchoring Fiscal Policy in Canada: The "10% Rule"

Highlights

If well invested, government borrowing to support the recovery from the COVID crisis should raise potential growth and help prevent a more permanent scarring of the economy.

However, to avoid an excessive build up of debt and future public debt charges, a federal fiscal plan for the recovery should be anchored in two goals:

1. achieving a primary deficit of 1% of GDP by 2024-25; and
2. containing future primary deficits to levels that keep public debt charges no greater than 10% of current revenues—what we call the "10% rule".

Under our baseline economic scenario, the fiscal track set out by the government in the Fall Economic Statement could meet the two goals by 2024-25.

Over the longer term, given the build up of debt to 2025, our simulations show that it will be considerably more difficult to meet the 10% rule and to ensure fiscal sustainability.

If interest rates average one percentage point below nominal GDP growth, just maintaining real program spending per capita at close to 2018 levels without raising new tax revenue will only be possible if we achieve productivity growth much higher than so far this century.

If interest rates are equivalent to nominal GDP growth, a less favorable but possible scenario, the 10% rule is not met in the longer term without raising taxes or reducing real per capita program spending.

The bottom line: the federal debt burden will be very difficult to manage over the longer term, drawing into question the capacity to fund large new programs or transfers to provinces without raising taxes.

The Choice of Fiscal Anchors

The federal and provincial governments have borrowed unprecedented amounts in 2020 to support workers and firms and they plan to borrow heavily in the next two fiscal years to support the transition to a stronger post COVID economy. We think that this borrowing, **if well invested**, should raise potential growth and help prevent a more permanent scarring of the economy.

The key issue will be to use these resources to enhance both private and public investment in productivity-enhancing technology, infrastructure and human capital and not just to support current consumption. While the federal government has made a provision in the Fall Economic Statement of $100 billion over the next three years for fiscal support, it has not yet revealed whether most of this will be used to raise future productive capacity, and hence growth, or simply to distribute support for current consumption. If the former, stronger future output will generate increasing revenues to pay for future interest costs. But if the latter, Canada will end up with the higher public debt charges and no extra revenue to cover them. In Chapter V, we provide some strategic guidance with respect to those policies that will promote investment and raise productivity.

Provided that the federal government does focus on productivity-enhancing investments, under a prudent plan the amount of fiscal support could be reduced from the current level of about $400 billion by about half in each of the next three years to achieve a primary deficit (deficit before public debt charges) of about 1% of GDP in fiscal years 2023-24 and 2024-25 (see Table 4 that reflects our baseline scenario for Canada). This fiscal plan would balance the need to support the recovery over the next few years with the need to reduce borrowing in order to avoid an excessive build up of debt and prevent an excessive rise in future public debt charges.

Table 4

FEDERAL BUDGET BALANCE: BASELINE SCENARIO

	Nominal GDP	Interest Rate on New Borrowings	Primary Balance/ GDP	Program Spending	Public Debt Charges	Total Budget Deficit	Accumulated Deficit/GDP	Public Debt Charges/ Revenues
	% Change	%	%	% Change	$ Millions	$ Millions	%	%
2018-19	4.2	2.2	0.4	4.7	23,266	-13,964	30.7	7.0
2019-20	3.6	1.6	-0.6	8.1	24,447	-39,392	31.2	7.3
2020-21	-5.1	0.7	-17.3	87.7	20,340	-400,000	51.1	7.4
2021-22	5.4	1.1	-6.9	-24.6	20,600	-180,000	56.3	6.2
2022-23	5.7	1.4	-3.1	-12.3	23,300	-100,000	57.3	6.5
2023-24	3.5	1.8	-1.7	-4.1	26,950	-70,000	58.2	7.2
2024-25	3.5	2.2	-1.0	-0.9	31,900	-58,079	58.4	8.3

In short, we suggest that a federal fiscal plan for the recovery should be anchored in the goals of (a) achieving a primary deficit of 1% of GDP by 2024-25, and (b) containing future primary deficits to levels that keep public debt charges no greater than 10% of current revenues.

We choose a primary deficit of 1% of GDP as the target for the deficit by 2024-25 because it constrains government spending to levels that can be funded with current tax revenues. To the extent the government chooses to spend more than that, it would have to raise more tax revenues.

And we choose the ratio of public debt charges to GDP as a target because this 10% rule would assure the public that it would always receive at least 90 cents worth of current services for their tax dollar.

The 10% rule is useful as a fiscal guideline over the longer term because it takes into account the impact of changing interest rates. To the extent that interest rates rise from the current low level in the future due to rising inflation, the 10% rule will require a more positive primary balance. At the same time, should growth turn out to be weaker than anticipated, and interest rates lower, the rule would permit the government to continue to run a primary deficit. Because it is a fiscal guardrail that incorporates both expected interest rate movements and productivity changes, it provides assurance that the government's fiscal balance will evolve in the direction of supporting the economy in periods of excess supply when employment is weak, and in dampening inflation in periods of excess demand when labour is in short supply.

Altogether, the proposed fiscal anchors would provide the assurances to financial markets that would support the Government of Canada maintaining its high credit rating.

Testing the Anchors with Simulations to 2031

The question is whether the track set out by the federal government in the Fall Economic Statement, consistent with our baseline scenario in Table 4, meets the two goals of achieving a primary deficit of 1% of GDP by 2024-25 and conforming with the 10% rule over the next four years, and beyond.

The answer is yes, for the next four years, if the baseline economic scenario (that also matches roughly that set out in the Fall Economic Statement) holds, and if the government is committed to its fiscal track. As shown in Table 4, with the debt-to-GDP ratio increasing to about 58% in 2024-25, public debt charges would rise to just over 8% at that time—conforming well with our 10% rule. Importantly, this track implies a very sharp reduction in program spending over the period to 2025.

However, the future is uncertain—growth in the second half of this decade may be weak, and/or interest rates may rise—and current plans are unlikely to be easily accommodated. We address the question below of what fiscal balance future governments will have to achieve in order to manage the public debt charges on the debt now being accumulated over the period up to 2025.

Six possible simulations are constructed on the basis of alternative assumptions for growth, interest rates and fiscal policy in order to test the sensitivity of the ratio of public debt charges to revenue over the period from 2025-26 to 2031-32 (Table 5). The simulations assume no tax increase to raise the revenue share of GDP above the current level of 15%. The first two simulations are based on a consensus economic view of nominal GDP growth averaging 3.5% per annum over the long term, and an interest rate on new government borrowing of 2.5%, representing one percentage point less than the growth rate.

Simulation 1, under which the government simply targets a primary deficit of 1% of GDP, turns out to be unsustainable. The deficit at the end of the period is $91 billion and the debt-to-GDP ratio is 62%. The simulation facilitates annual spending growth of 3.5%, in line with revenue growth, but it also implies that debt service charges consume almost 12% of revenue, breaching the 10% rule.

Even if the primary balance is held at zero by lowering annual spending growth, as in Simulation 2, public debt charges as a share of revenue rise to 11% by 2031-32, again breaching the 10% rule and compromising longer-term sustainability.

Stronger growth assumptions are required, such as in Simulation 3, to come close to meeting the 10% rule. For example, it is possible that strong investment by private enterprise and governments over the decade raise productivity and yield an average 4.5% growth in GDP between 2024 and 2031, while keeping inflation in check and allowing monetary policy to maintain the same 2.5% cost of new borrowing. In this favorable scenario, program spending could grow at 4.0% annually, and the public debt charges reach only 10.4% of revenue in 2031.

If interest rates and growth projections remain the same as in Simulations 1 and 2, then meeting the 10% rule requires a primary *surplus* of almost 2% of GDP (Simulation 4). This would imply program spending growth of only 1.4% in nominal terms roughly equivalent to a 2% decline in real per capita program spending every year over the six-year period to 2031. This would be much tougher than what was done by the federal government from 1995 to 1997 and is unlikely to be achievable.

Table 5

FEDERAL BUDGET SIMULATIONS AS AT 2031-32

	Primary Balance	Public Debt Charges	Total Budget Balance	Accumulated Deficit/GDP	Program Spending 2031/2024	Public Debt Charges/ Revenues
	$ Millions	$ Millions	$ Millions	%	Annual % Change	%
Simulation 1: Primary deficit = 1% of GDP, i = 2.5%	-33,307	58,042	-91,349	62.0	3.5	11.8
Simulation 2: Primary deficit = 0, i = 2.5%	0	53,921	-53,921	54.7	3.2	11.0
Simulation 3: Growth = 4.5%, Primary deficit = 0, i = 2.5%	0	53,934	-53,934	51.6	4.0	10.4
Simulation 4: Primary surplus = 2% of GDP, i = 2.5%	66,614	43,758	22,856	40.7	1.4	8.9
Simulation 5: Primary deficit = 0, i = 3.5%	0	65,608	-65,608	55.8	3.2	13.4
Simulation 6: Total deficit = 0, i = 3.5%	57,473	57,473	0	46.4	1.4	11.7

Note: The assumed growth rate for the economy is 3.5%, not including Simulation 3 which is at a high growth rate of 4.5%.

In summary, if interest rates average 2.5%, or one percentage point below nominal GDP growth (a reasonable planning assumption), just maintaining real program spending per capita at close to 2018 levels without an increase in tax revenues will only be possible if we achieve productivity growth much higher than we have achieved so far this century.

Now under the less favorable but entirely possible scenario that interest rates average 3.5% while growth remains at 3.5% (the very long-term global average relationship between the two variables), the 10% rule is not met without increasing taxes or reducing real per capita program spending. In **Simulation 5**, we set the primary deficit at zero, implying a total budget deficit of $66 billion comprised entirely of public debt charges, and public debt charges consume over 13% of revenues by 2031. In **Simulation 6**, we see that even by targeting a total deficit of zero, requiring a primary surplus of $57 billion, the public debt charges are still almost 12%, again threatening fiscal sustainability.

The bottom line is that the unprecedented spending needed in 2020 and 2021 to manage the global pandemic and the follow up planned spending for 2022 to 2024 will create a debt burden that will be very difficult to manage over the longer term. If taxes are not increased to raise the ratio of federal revenues to GDP, program spending in real per capita terms will have to return to 2018 levels. No expansion of ongoing major programs or transfers to persons, businesses or provincial governments, funded by increased borrowing, will be possible without seriously breaching the 10% rule. Sustained breach of that rule would eventually lead to major retrenchment as it did in the early to mid-1990s. If the federal government wishes to pursue the expansive plans alluded to but not costed in the Fall Economic Statement, or subsidize the provinces to do so, then federal taxes will have to be raised. And if the provinces wish to pursue the plans outlined in their budgets without receiving additional federal transfers, they too will have to raise taxes.

Proposed Planning Assumptions for Businesses to End of 2022

Much as we thought last spring, businesses can expect policy interest rates to remain at their "lower bound" in both Canada and the United States, with longer-term interest rates rising from their current record-low levels, but only very modestly (Table 6). The WTI oil price is projected to strengthen on balance from current levels, but still be lower at the end of 2022 than before the pandemic. The Canadian dollar should evolve in a range of 75-79 U.S. cents to the end of 2022.

Table 6

PLANNING PARAMETERS		United States	Canada
GDP Growth (% at Annual Rates)			
	2019	2.2	1.9
	2020	-3.6	-5.7
	2021	3.6	3.6
	2022	3.3	3.7
GDP Level as % of Q42019			
	Q4 2020	-2.6	-4.9
	Q4 2021	3.2	3.9
	Q4 2022	2.5	2.7
Policy Rate (%)			
	End 2019	1.75	1.75
	End 2020	0.25	0.25
	End 2021	0.25	0.25
	End 2022	0.25	0.25
10-year Treasury Yield (%)			
	End 2019	1.92	1.7
	End 2020	0.9	0.75
	End 2021	1.3	1.2
	End 2022	1.7	1.6
Canadian Dollar Exchange Rate vs U.S. Dollar			
	End 2019		0.76
	End 2020		0.77
	End 2021		0.74-0.79
	End 2022		0.74-0.79
WTI Oil Price (US$ per Barrel)			
	End 2019		61
	End 2020		45
	End 2021		40-50
	End 2022		45-55

III. The Geo-Political and Trade Environment

Global Challenges Requiring Adept Diplomacy and Coalition Building

Highlights

The geo-political outlook for 2021 draws out severe global and regional challenges—like the pandemic and climate—but also some indication that diplomacy and coalitions of interests may foster new approaches that support progress.

A U.S. administration more committed to multilateralism may be more effective in managing the relationship with China that has largely overcome the effects of COVID, resumed its fast economic rise, and continued to flex its muscles internationally.

In this evolving environment, Canada has an opportunity to solidify its relationship with the United States, contribute ideas, and advance its own interests.

On the threshold of 2021, Canada faces a geo-political environment consumed by a multitude of uncertainties. Global challenges call for proactive management by governments, nimble international diplomacy, creative approaches, and regional and transnational coalitions of interests.

Certain challenges, such as the **COVID-19 pandemic** and **climate change**, present grave threats on a planetary scale. Widening **income inequality, racial and social tensions**, and **political polarization**, abetted by the **malevolent use of social media**, pose risks to the health of the world's democracies. **Diminished U.S. leadership** has weakened traditional alliances and multilateral structures that had provided the foundation for shared prosperity in the post-war period. Emboldened **authoritarian regimes** are confronting the security of a hitherto familiar world order.

There are encouraging indications that the international community—governments, corporate interests and civil society—beyond simply acknowledging the severity of these concerns, are forming partnerships to address them. The change in the White House should provide a boost to these cooperative efforts in the next four years.

Seeking the mitigation and eradication of COVID will dominate much of the international agenda throughout 2021. There is well placed optimism from early trials that widespread immunization can proceed in the second half of 2021, with attendant positive effects for the global economy. Recognizing the vulnerabilities of an interconnected world, the World Health Organization (WHO) has led partnerships of governments, the international science community, pharmaceutical manufacturers and philanthropy to establish the COVAX initiative to ensure the development, manufacture and distribution of a vaccine throughout the developing world. President-elect Biden has pledged to reverse the United States notice of withdrawal from the WHO.

Beyond COVID, as stressed by President-elect Biden in his early discussions with world leaders, climate change will be prominent on the global agenda. First up for the United States will be an Executive Order to rejoin the 2015 Paris Agreement. In North America and in Europe, one may anticipate an acceleration of public and private investments in infrastructure and research for the transformation of energy systems. These decisions will be driven by post-COVID stimulus programs, carbon pricing mechanisms and/or regulation, shareholders' investment (e.g., environment, social and governance) preferences, and risk management by financial institutions.

China has already emerged as a global super power. Adjusting for the prices of goods and services, China was the world's largest economy in 2019. From then, by 2022, it is projected to grow by 16%, compared with less than 2% for Europe, the United States, Japan, and Canada. Geo-strategically, China's intentions regarding Taiwan, the South China Seas and beyond, not to speak of the establishment of new port facilities outside the region, constitute a series of deliberate steps to affirm its status as a dominant regional and global force. Related geographically are China's encroachment on Hong Kong's political autonomy, and uncertainty over North Korea's nuclear weapons ambitions. Both are flashpoints which could develop into grave international crises which will require U.S. leadership, supported robustly by Asian and western allies.

Unlike its predecessor's "go it alone" strategy, the new U.S. administration will seek to build coalitions of like-minded governments to push back against China's regional gamesmanship, human rights practises, and perceived predatory economic activities. Close coordination between governments and transnational corporate interests to promote changes in Chinese business practises, safeguard intellectual property, and preserve national security, will be a high priority. Greater predictability from a Biden presidency, including less gratuitous rhetoric, should result in improved diplomatic engagement with Beijing, a more stable relationship, and opportunities for co-operation on global challenges such as climate change and the prevention of pandemics.

A U.S. administration that is more committed to multilateralism may assist with a necessary global response to the impacts of the pandemic in emerging and developing economies. The COVID crisis is reversing the progress made since the 1990s in global poverty; it is estimated that 90 million people could fall below the threshold of extreme deprivation.[14] Meanwhile, governments in emerging and developing countries are falling deeper into debt, with already some defaults and restructurings, and more to follow. The G20 agreed to a standstill of repayments of official bilateral debt for the world's poorer countries in 2020. More concerted global action will be necessary.

Very much on the radar of western security and diplomatic experts are regional conflicts: new alignments in the Middle East theatre exacerbating Sunni-Shia tensions, Russia's deployment of covert military assets to Central Asia, Ukraine and the Baltic, and ongoing bitter religious conflicts on the African continent provoking large movements of migrants.

Meanwhile, democracies have to deal with concerns posed by authoritarian governments, within and outside the NATO area. Hostile nations are exploiting cyber space in order to manipulate social media and aggressively attack western institutions and electoral processes, while also posing constant risks to our infrastructure, economic interests, and national security.

Governments and regulators, as well as technology behemoths, such as Facebook, Google and Instagram, have to grapple with the difficult issue of balancing freedom of expression against the malign manipulation of social media aiming to foment civil unrest. Internationally, we foresee a Biden administration working cooperatively with governments and the private sector in arriving at regulation or protocols designed to counter the penetration of internet networks by malevolent actors.

Against this difficult backdrop, Canada may gain some comfort from President-elect Biden's lengthy track record in foreign affairs and of his campaign platform broadly aligned with Canada's interests.

While there will be stumbling blocks and challenges (e.g., Keystone, Buy America), there are similarities with traditional Canadian policies, both in approach (emphasis on multilateralism and coalition building) and in substance (pursuit of western security interests, democratic governance, environmental sustainability and the observance of human rights norms). The selection of the foreign policy team (e.g., Antony Blinken as Secretary of State, and Jake Sullivan as National Security Advisor) bears this out.

Should Canadian decision-makers bring credible ideas to the table regarding shared international objectives, this could facilitate access to, and attention from, high levels in Washington—gold coin in the realm of Canada-U.S. relations.

Bennett Jones

The Transition to a Biden Administration and Trade Policy Priorities for Canada

Highlights

The coming into office of the Biden administration will set a new tone, and instill a new dynamic, in global trade relationships.

For Canada, it is an opportunity to leverage our economic relationship with the United States and to pursue global trade rules, agreements, and business practises supportive of selling more goods and services to the world.

Specifically, Canadian priorities include:

- using the election of Joe Biden to secure the benefits of the CUSMA and to work collaboratively on global trade reform;
- stepping up efforts, in concert with United States and other allies, to strengthen the WTO;
- pursuing improved rules for digital trade, trade-distorting subsidies, and competition;
- diversifying our trade into dynamic Asia and Europe; and
- pursuing a long-term strategy with China, including both enhanced trade disciplines and co-operation on matters of shared interest.

After four years of a distinct brand of America First policy under President Trump, the Biden administration will set a new tone, and instil new dynamics, in global trade that will impact both bilateral and multilateral trade relationships. U.S. policy will nonetheless continue to be driven by U.S. interests. Indeed, while President Biden will govern a divided nation, trade is a domain where he may succeed in securing a measure of bipartisan co-operation.

Canada must situate in its own trade policy and priorities in this new environment. This chapter reviews what Joe Biden's electoral victory means for American trade policy, what Canada should do to prepare, and how in this context Canada may engage with other countries and at the World Trade Organization (WTO).

The Biden Administration's Approach to Trade

Biden's trade policy will be more measured than Trump's but focused very much on what is best for American interests. It will be less erratic and tempered by a belief that the rule of law in international trade relations is good for Americans. However, Biden's approach may pose bigger challenges for some Canadian interests than Trump's did.

Biden will not put trade near the top of his priority list. His main priorities include the pandemic, economic recovery, climate change, and healing a fractured country. However, he will not be able to avoid dealing with a number of trade issues in the coming months. Indeed, trade considerations will permeate many aspects of domestic policy priorities.

A key issue is that the "trade promotion authority" (TPA) granted by Congress to the administration expires on July 1. As a practical matter, this means that the United States will be unable to negotiate trade deals as of about April 1, 2021, until such time as Congress grants new authority. Securing trade promotion authority is a policy intensive process for both Congress and the administration, and neither will have this near the top of the priority list. It could well take at least a couple of years to get new authority. Trade policy is full of details, and Biden's team will not be able to focus on the elements that matter before late spring or early summer.

This is not to say nothing will happen immediately in the trade space—in these troubled economic times, there will be many petitions to trade agencies of the U.S. government seeking protection against imports, including imports from Canada. Any administration is already well armed with legislative authority to deal with such matters. Most investigations into imports can be triggered by private sector actors, and the administration is required to investigate within specific legislated time frames. There will be antidumping investigations against allegedly dumped imports, countervailing duty investigations against allegedly subsidised imports, safeguard investigations against imports alleged to be causing serious injury to American producers, and Section 301 and Section 337 investigations against a range of alleged unfair foreign trade practises, including alleged violations of intellectual property rights. This spells trouble for many Canadian producers, for example softwood lumber suppliers. Mexico will face the added burden of being targeted under the rapid response mechanism of the Canada-United States-Mexico Agreement (CUSMA), which can result in duties on products from specific companies.

On the brighter side, we expect that the new administration will be much less likely to use Section 232 as a protectionist weapon. Trump used this tool to slap tariffs on Canadian steel and aluminum imports alleging they were a threat to U.S. national security. Many Republicans opposed the President's use of Section 232 and there were several Republican legislative initiatives to constrain the use of the president's trade powers. Clearly, there is some scope for President Biden to work with Congress.

Trade Issues Likely to Play Out Early in the New Administration

The pursuit of a number of Biden's top policy priorities will generate trade impacts on other countries even if trade is not the intended, or the stated, driver. For example, addressing economic recovery through an infrastructure program with Buy America features, or climate change by shutting down the Keystone XL project, will adversely impact Canadian interests.

In addition several trade matters will be hard to avoid in the near term. These include dealing with China, the crisis at the WTO, foreign discrimination against American goods, and ongoing trade negotiations, notably with the United Kingdom.

Economic Recovery

Biden's insistence that public monies for large infrastructure projects be spent only on American products and jobs entails a massive Buy America program that would exclude Canadian businesses from procurement markets. There is no procurement chapter applying to Canada in the new CUSMA, and thus the fallback is the WTO. The Canadian government should take a hard look at the legal case to challenge this program as a violation of the WTO Agreement on Government Procurement. It should also work with Canadian stakeholders to minimize the adverse impacts on Canadian interests by building on successful advocacy efforts from the last few years.

Climate Change

Climate change will be a key priority of the Biden administration. With the appointment of John Kerry as climate czar, the president-elect is taking steps to ensure an all-of-government approach is implemented to advance this priority in both domestic and international affairs.

Biden has promised to rescind the Presidential permit for the Keystone XL (KXL) pipeline. This is important for Biden's base, and while it would be damaging economically to Canada, and in fact, achieve no reduction of emissions in the United States or globally, it could be an easy political win.

President Biden will rejoin the Paris Agreement on climate change, something he can do without the support of Congress. However, it will be more difficult for him to get Congressional support for laws to reduce carbon emissions in the United States. He may try to reduce emissions through executive orders and regulatory actions in cases where the administration has authority to do so.

If the administration succeeds in imposing emission reductions onto trade-exposed sectors of the economy, then the implementation of border-adjusted carbon taxes to offset the competitive edge of imports from countries with less onerous carbon policy is probably inevitable. At least one very credible American trade expert thinks such measures could attract bipartisan support and would be WTO compliant.[15] Border taxes would also generate revenue. U.S. interest would be intensified if the European Union moved forward in this direction. Canada itself has staked some ground. The Fall Economic Statement states that "the government is exploring the potential of border carbon adjustments, and will be discussing this issue with our international partners."

Large-scale subsidy programs for green technology that would discriminate against foreign suppliers would pose challenges to Canadian interests by eroding the competitiveness of our firms in global markets.

Canada will need to defend vigorously its interests and move early to engage the United States on cooperative approaches to energy and climate that would keep the border open to Canadian goods and services. It is only within this wider context that KXL stands any chance of survival.

China

While there is a broad bipartisan consensus in the United States that China poses a threat to American interests, Biden has been clear that China is a "competitor" and not an "enemy". The Biden administration is likely to pursue a more rational and predictable approach toward China than has been the case under President Trump. In a welcome departure from Trump's approach, Biden has signalled that he wants to work with allies in bringing China more effectively into the rules-based system. This would mean a change to Chinese practises with respect to the behaviour of State-Owned Enterprises (SOEs), and reductions in subsidies, particularly industrial subsidies. Biden will also have to decide what to do about the tariffs Trump unilaterally applied to China.

While acting forcefully on trade, Biden may also look to areas of co-operation with China, including climate change, renewable energy, and health.

This two-pronged approach to China, and United States willingness to join with allies in the cause, will be in Canada's interest. There should be an early signal that Canada is willing to work with the new administration on this agenda.

Crisis at the WTO

As a supporter of traditional American multilateral diplomacy, the Biden administration will want to show continued support for the WTO. In particular, it will want to engage constructively in appointing a new Director-General and in finding a solution to the impasse largely created by the Trump administration over the Appellate Body. It will also want to use the WTO and its dispute settlement system as part of its China strategy. There will be significant opportunities for Canada to work with the new administration in pursuit of Canadian objectives for WTO reform. We return to these ideas in the section on the WTO below.

Market Disadvantage for American Goods

American businesses and agricultural producers are losing ground to foreign competitors in lucrative markets in Europe and the Pacific because U.S. producers face higher levels of protection in these markets. Indeed, unlike Canada and several other countries, the United States does not have a free trade agreement with the European Union and it is not part of the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). The current situation gives Canadians an opportunity to make inroads into European and Pacific markets while their American competitors remain at a disadvantage. However, U.S. business interests will exert pressure on the administration and Congress to rectify the situation by negotiating similar agreements with these regions.

Ongoing Trade Negotiations

The Trump administration has completed so-called Phase I agreements with China and Japan and it intended to pursue more comprehensive agreements at an early date.

An agreement is also being pursued with the United Kingdom. It may be seen as particularly attractive because the United Kingdom, the world's fifth largest economy, leaves the European Union on December 31. Indeed, some Washington insiders think it might even be possible to get an extension to the current TPA authority limited to the United Kingdom negotiations to allow time for them to be concluded. The United Kingdom does not raise serious concerns among Democrats about the labour and environmental impacts of trade agreements.

As the administration and the Congressional leadership take full stock of the state of play, and of opportunities for trade negotiations, trade may move up the policy priority list and the TPA may be adjusted accordingly.

An Opportunity to Reboot the Canada-U.S. Partnership

Canada should move strategically to engage the new administration on strengthening North American co-operation as a critical step in securing a better future for Canadian business in the post-COVID world. Canadian officials are already engaged in this sort of planning. Canada should demonstrate how it be can be a helpful partner, with useful ideas. If Canada waits until the United States fleshes out its own agenda, actions may be cast in stone, and they may not accommodate Canadian interests. No doubt, old bilateral trade irritants with the United States will persist. New ones may arise. While standing up for Canada, our government needs to try to ensure that the irritants do not undermine the underlying strength of the bilateral trade relationship. Concurrently, working together on global challenges increases the prospect of successfully managing bilateral disputes.

To be successful in its U.S. engagement, Canada needs to have a clear sense of its objectives and goals—the key elements of trade reform and trade disciplines needed to bolster Canadian trade competitiveness. This work would also pay dividends in furthering wider co-operation, for example with Mexico in working toward the smooth implementation of the CUSMA.

As part of the same strategy, Canada must also be prepared to firmly defend its interests if the United States, or any other country, takes unjustified action against Canadian exports. In the case of Trump's tariffs on Canadian steel and aluminum exports, Canada demonstrated that carefully calibrated retaliation was a decisive tool in getting the Americans to change their position. Many Canadians do not fully appreciate how important the Canadian market is to Americans. For instance, in the high value added area of agri-food consumer products, Canada imports roughly the same amount from the United States as China, Hong Kong, Taiwan, Japan and South Korea combined.[16]

There are many trade policy matters for early discussions between Canada and the new administration.

Strengthening and Reforming the WTO

Now is the time to make a serious effort to strengthen multilateral trade co-operation. The Biden administration will likely be supportive. As the convenor of the Ottawa Group, Canada can be a facilitator.

To reinvigorate the WTO and restore its potential as the primary vehicle for international trade co-operation, three things are desperately needed.

- **First, the WTO must complete the process of selecting a new Director-General.** The clear front runner is Dr. Ngozi Okonjo-Iweala, a former Finance Minister of Nigeria and Managing Director of the World Bank. However, the Trump administration refused to support her appointment. The issue should be discussed with the Biden transition team to facilitate a decision as soon after January 20 as possible.
- **Second, WTO members must find a way of restoring the Appellate Body, which is vital for the dispute settlement system and the credibility of the organization.** The creation by a group of members, including Canada, of an interim appeal mechanism shows that an appellate function is considered essential. Many ideas have been advanced about how to resolve the crisis. A solution is within reach for reasonable people. Once again this is a matter which should be taken up with the new administration in Washington.
- **Third, a credible program needs to be developed to restore the negotiating function of the WTO.** This would involve various negotiations already underway in the WTO and a work program for elements like those described below in this section. Having a U.S. administration that believes in multilateral co-operation will facilitate this task. Members should work to put such a program in place at the next Ministerial Conference of the WTO, which will probably take place sometime in 2021.

Working Toward a Framework for Digital Trade

The digital economy is the most dynamic factor in international economic relations and it is critical that rules be developed and implemented for trade to make the best contribution to growth and widely-shared benefits in the global marketplace. The competition between the United States and China in this area is a point of serious contention that risks splitting the world into two digital universes. Work in digital trade is a priority in the OECD and at the WTO. Actual provisions on digital trade have already been incorporated into the CPTPP and the CUSMA. Also noteworthy is the work in this area undertaken by New Zealand, Chile and Singapore which, resulted in the Digital Economy Partnership Agreement signed earlier this year. This self-standing agreement could lead the way to a series of similar agreements among other countries, pending the incorporation of such provisions into various trade agreements including potentially the WTO.

Reducing the Use of Trade Distorting Subsidies

As governments emerge from the pandemic heavily indebted, this is an excellent time to try to improve WTO disciplines aimed at reducing the use of trade-distorting subsidies. Before the pandemic, the United States, the European Union and Japan were already discussing how to engage in such negotiations with China. For Canada, heavily dependent on the export of primary commodities that are often subsidised by foreign governments, this is a major opportunity. A successful negotiation would allow governments to focus their subsidies in areas that will promote improvement in their economies, while avoiding those that are most trade distorting. Subsidies less likely to distort trade include investments in infrastructure and health care systems.

Making Trade in Medical Products and Services More Resilient and More Open

The pandemic illustrated the fragility of some supply chains and the risk of trade-distorting measures for critical supplies—underscoring opportunities for global co-operation. In the early weeks of the pandemic, there was a rush to secure supplies of personal protective equipment and various other medical supplies. Shortages resulted and many countries erected export controls to protect scarce domestic supplies. Similar pressures arose in the food and agricultural sector. Governments began outbidding each other. Some argued that each country should be securing its own domestic production to ensure adequate supplies in time of crisis. Many are now recognizing the shortcomings of such an approach. Canada is already playing a leading role through the Ottawa Group in proposing a more resilient system to manage a future pandemic more effectively.

Strengthening International Co-operation on Competition Policy

There is growing concern about the threat to competitive markets of the phenomenal increase in market power and concentration in the hands of a few dominant corporations—thus a question of whether trade policy could help advance a coherent international approach. Governments have been taking action within their domestic or regional (i.e., European Union) frameworks against anticompetitive behaviour but their approaches on practises that cross borders often differ. Some free trade agreements promote co-operation among competition authorities, but so far there has been no serious effort to develop and enforce rules on a multilateral basis. While there could well be reticence in the United States because several dominant American companies might be targeted, new disciplines would also impact on dominant Chinese enterprises.

Global Challenges for Canada

Quite apart from dealing with a new U.S. administration, and cooperating with it on issues of common interest, Canada has to respond to shifting trade dynamics and ensure that we are in a position to sell goods and services and to trade in growing economies and new markets.

Dealing with Fast-Growing Economies of the Pacific

Leaders of 15 nations of the Pacific captured the world's attention on November 15 when they signed the Regional Comprehensive Economic Partnership (RCEP). This deal, eight years in the making, links the 10 members of the Association of Southeast Asian Nations (ASEAN) with China, Japan, South Korea, Australia and New Zealand. It is the first free trade agreement between Japan and China, and between Japan and Korea. It consolidates earlier separate trade agreements between the ASEAN countries and each of the other five nations now signatories of RCEP.

While the RCEP is not of the same quality as the CPTPP, it establishes a common set of rules of origin which is likely to strengthen regional supply chains in the orbit of China. If a good produced in the region qualifies for free trade access in the market of any one member, it similarly qualifies in the market of all countries of the region. While experts are still analysing the RCEP agreement, some weaknesses and gaps relative to the CPTPP are evident. Duty elimination will cover only 90% of goods and it will take 20 years to phase in; coverage is particularly weak for agricultural products. There is no chapter on digital trade, nor on state-owned enterprises. Provisions on services, and on product regulations that impede trade, are less well developed.

Nonetheless, the question is posed whether accession might make sense for Canada. We have been struggling for years to get a negotiation with

ASEAN launched, and there is some attraction to having an agreement with China which could be a possible stepping stone to something better.

There is some time to reflect on the question. The RCEP will not come into force until it is ratified by at least six ASEAN countries and three of the other five signatories, which could delay ratification.[17] Accessions cannot take place until at least 18 months after that, and are subject to the consent of all the parties to the agreement and "any terms or conditions that may be agreed."

Dealing with China

China is too big to ignore: its economy, already the largest in the world by some measures, and still among the fastest-growing, is moving rapidly from being a low-cost producer to a leader in advanced technologies. It is already the largest trade partner for many countries in the world. Interestingly, despite COVID, and despite tension in the bilateral relationship, Canada's merchandise exports to China in September 2020 were 12.5% greater than a year earlier—this, while Canada's total merchandise exports dropped 7.4% and exports to the United States were down 10.4%.[18]

At the same time, geo-political tensions and the real prospects of an economic cold war from which no one will benefit represent a significant risk for the global economy. China's behaviour with respect to the Uighurs and Hong Kong and the South China Sea, as well as the erratic actions of the Trump administration, have aggravated a strategic rivalry between the world's two largest economies and dominant geo-political forces. Canada's own relations with China have deteriorated following the arbitrary detention of two Canadian citizens (Michael Kovrig and Michael Spavor) after our arrest of Huawei's Chief Financial Officer, Meng Wanzhou, further to an extradition request from the Trump administration.

How we deal with China is a matter that is critically important for Canada's economic future: short-termism is not a viable option; focusing on the long game, while difficult today, is essential. Just as in the United States, the pendulum of power shifts in China from one leadership to another. While there is no doubt about the tightening that has taken place under the Xi Jinping regime, at some point if China's history is a guide, those favouring opening up and greater reform will once again be in the ascendancy. Shutting ourselves out of an economic relationship with China today would be a serious handicap in pursuing longer-term opportunities.

In the short term, as long as the situation of the two Michaels and Meng Wanzhou is not resolved, there is little the government can do to make Canadian exports to China more secure, but the ground needs to be laid now for future negotiations in better circumstances. Such work needs to operate on two tracks. The first track is negotiation with China on industrial and agricultural subsidies, and on reform of rules to ensure that SOEs engaged in international trade operate on the basis of market signals rather than government fiat. The Biden administration will be focused on this challenge, and this offers the best prospect Canada has for encouraging reform in China. The second track is to seek areas of co-operation that achieve mutual benefit. In the overall process, Canada has to advance its own interests, including our exports of goods and services, and two-way trade in technology. We need to be able to compete in China with the United States and others.

Making Trade Agreements Work for Canada

Canada should continue efforts to ensure that the major trade agreements concluded in recent years deliver results for Canadian exporters that are noting, with some justification, that non-tariff barriers frustrate what was negotiated. The government should work with its free trade partners in the CUSMA, the CPTPP and the Comprehensive Economic and Trade Agreement (CETA) to remove residual barriers hindering our exports.

The government has now concluded an agreement with the United Kingdom to continue CETA-like treatment when the United Kingdom completes its transition out of the EU on December 31. The agreement is a foundation to initiate new negotiations in 2021, to improve on the CETA, and to open new bilateral opportunities.

Importantly, the government needs to identify how best to encourage and assist Canadian businesses to take advantage of the new trade agreements.

Despite unprecedented efforts to explain the new market openings to businesses, and to offer them support, the private sector uptake has been disappointing. Some kind of new approach should be tried. While the government knows all about what was negotiated, it is the private sector that actually engages in trade and understands the intricacies of market operations. Individual Canadian businesses are unlikely to have fully digested what the new agreements could mean for their markets and for their bottom lines. Perhaps it would be useful to experiment in a few areas that appear promising with small, carefully selected teams from government and businesses actively engaged in particular markets of interest. The objective would be to review how negotiated trade provisions can open concrete and profitable market opportunities for business, and then to pursue those aggressively.

IV. The Pandemic and the Labour Market

Managing the Disruption and Preparing for the Future of Work

Highlights

The impacts of the COVID crisis for Canadian workers has been severe. The unemployment rate, down from a peak of 13.7% in May 2020, is still 8.5%, with low-wage workers most seriously affected.

Although approximately 80% of jobs have been recovered as of November, it will still take until 2022 for employment to return to pre-pandemic levels. Some jobs, in fact, will not return.

There have been hits and misses in the suite of programs introduced in Canada since the onset of the pandemic to bridge workers and employers to the other side of the crisis.

As our economy mends and as emergency programs are pulled back, workers, employers and governments must use the time to get ready for the labour market of the future as shaped by technology and other structural factors.

Some policy preoccupations that dominated pre-crisis like income inequality, the protection of workers in the gig economy, and the diversity of the workforce, will again be salient.

Drawing lessons from the crisis, an independent review of the income safety net could be commissioned to deliver recommendations by mid-2022.

Critically, employers and governments have to collaborate to address the mismatch of skills that may impede the recovery, and to invest in a workforce that may be able to take advantage of the opportunities created by new technology as it permeates all sectors of the economy.

The ultimate goal must be a more inclusive, productive, and resilient labour force.

The COVID-19 pandemic has profoundly disrupted labour markets, while exacerbating or accelerating structural trends affecting workers and employers, requiring policy responses that address both immediate pressures and the future of work.

This chapter reviews the impact of the pandemic on employment, the early responses of government, and steps to ensure that Canada builds a more inclusive, productive, and resilient workforce for the longer term.

The Impact of the Pandemic: Disruptions and Setbacks

Prior to the pandemic, with historically low unemployment rates, policy attention on labour markets focused on meeting the demands of employers, while addressing structural trends affecting the distribution of risks, income, and opportunities for workers.

- **Employers in many sectors and many parts of the country cited labour and skills shortages as a critical impediment to business growth**. The gaps were particularly acute in the advanced technology sectors and in skilled occupations. Governments and employers were seized with the need to expand the quantity and the quality of labour, including through economic immigration, apprenticeships, skills training, and education.
- **Looking ahead, the impact of technology on jobs was a key preoccupation.** Automation posed a risk not only to low-skilled jobs as historically but, with advanced robotics and artificial intelligence, to skilled jobs. For example, the OECD estimated that 14% of jobs (on average in the OECD) faced a high risk of being automated, and that some 32% would undergo substantial changes in terms of the quantity and quality of their tasks.[19]
- **There was attention to a rising proportion of low-income, low-security jobs.** The shift away from traditional employment, particularly in the gig economy, often meant low salaries, with fewer benefits, and lesser social protection.
- **Employers were pursuing greater diversity in the labour force, but with uneven results.** Although the rate of female participation in the labour force in Canada had risen, the gender wage gap had not changed in a decade. Moreover, other populations (racialized Canadians, persons with disabilities, Indigenous Peoples) still faced large gaps.

The pandemic had early and brutal consequences on the Canadian labour market.

- **Unemployment rose sharply.** It spiked to as high as 13.7% in May 2020. As the economy reopened, it fell to 9% by September and stayed at roughly that level as the second wave of the pandemic hit in the fall; it is now 8.5%. Despite the programs discussed below, Canada is still at the top end of unemployment rates among G7 countries.[20]
- **Job losses have been concentrated in a limited number of business sectors.** The losses were sudden and massive in the retail, entertainment, transportation and hospitality sectors. Accommodation and food services alone experienced a 46.6% loss of employment, and 63% loss in hours worked between February and May 2020.[21] While there was a substantial improvement in this sector in the summer, it did not continue in the fall.
- **Jobs losses have hit disproportionately low-wage workers**. In the March to April period, low-wage employees experienced a 38% drop in employment, while for other paid employees the drop was 13%.[22] This pattern has persisted. From February to September, the percentage drop in employment was 15.6% for those earning less than \$14 an hour; whereas, there was an increase of 8.7% for those earning \$40–\$48 an hour.[23]

- **Nor surprisingly, long-term unemployment has risen sharply.** As of November, some 443,400 workers had been unemployed for more than six months, compared with 178,700 in February 2020.[24] This is significant because re-entry in the workplace is more difficult the longer the period of unemployment.

The disruption not only required early responses to stem job losses and protect the income of workers, but it also shed new light on challenges and opportunities for the longer term.

On the positive side, the pandemic has demonstrated that while a threat to traditional jobs, technology is also an enabler of flexible work arrangements, including work from home. For a range of sectors and occupations, the Internet and broadband allowed activity to continue. E-commerce is flourishing, professional services are rendered remotely, and meetings are held virtually.

Indeed, those able to work remotely have not been significantly impacted by the pandemic. Employees in governments, the financial sector, and other professional and high-wage occupations transitioned well to working from home.

Post-pandemic, work will remain mobile. A Statistics Canada survey in May noted that close to one quarter of businesses—and in information and cultural industries sector and professional, scientific and technical services sector close to one half— expect that 10% or more of their workforce will continue to telework or work remotely post-pandemic.[25] Some workers would prefer a mix of work from home and at an office in the post-pandemic world. Technology may accommodate different preferences and practises.

On the negative side, in addition to overall disruption, the pandemic has represented a difficult setback for equality and diversity in the workplace.

- **Job losses have affected visible minorities disproportionately.** Statistics Canada estimates that compared with one year earlier, the unemployment rate in October 2020 as higher to a greater extent for Chinese (+5.9 percentage points), Black (+3.8), South Asian (+3.4) and Filipino (+3.3) Canadians than for those who are not Indigenous and not a visible minority (+2.6).[26] This is consistent with the higher representation of racialized Canadians in low income jobs, which were hardest hit.
- **Youth have been impacted disproportionately.** Again, this is not surprising given their higher rate of employment in the hospitality industry and in seasonal employment that was also sharply cut back.
- **Gender equality also suffered, particularly in the early onset of the pandemic.** Women lost jobs at a greater rate than men, and single mothers with young children were hardest hit at the onset of the pandemic.[27] As activity recovered in the summer, unemployment rates between men and women became similar and the wage gap closed.[28] This is in part a reflection of the fact that women dominate employment in the essential services in the health care and education fields. This positive outcome, however, masks potentially rising challenges.

The setbacks for inclusion and diversity are multi-faceted and they may be long lasting. For example, women exited the workforce in greater number than men,[29] and they returned to work at reduced hours, on average, compared to men.[30] In response, the government has committed to work with provinces on affordable childcare. The Fall Economic Statement allocated funds for an early learning and childcare secretariat, and announced a task force to provide advice. In the interim, the government has proposed temporary support totaling up to $1,200 in 2021 for each child under the age of six for low- and middle-income families who are entitled to the Canada Child Benefit (CCB).

Although approximately 80% of jobs have returned as of November, the economic scenarios for the next two years provide that Canada is likely to exhibit unemployment rates higher, and labour force participation rates lower, than pre-pandemic until at least 2022. The recovery of jobs and income will be determined in part by the changes in consumer behaviour, and by the extent to which skills in the labour force match correspondingly the needs of employers.

It will be difficult for some time to discern what is a temporary disruption and what is more permanent, and when and how underlying structural factors will again dominate labour market developments. For example, as schools return to pre-pandemic operations, it is anticipated that female participation will readjust, but it is unclear whether it will return to pre-pandemic levels without further consideration of our existing childcare policies. Technology and flexible work arrangements will continue to support existing jobs, and contribute to new job creation, but the wider impact of technology remains uncertain.

Correspondingly, policy must be concerned not only with the short-term disruption caused by the pandemic, but with its longer-term impacts, the structural trends, and the goal of a more inclusive, productive, and resilient workforce.

The Government Response to the Pandemic: Hits and Misses

The Canadian government responded quickly and generously to the pandemic with both individual income and corporate relief. Canada was one of the few jurisdictions in the world to offer both direct income support to workers sidelined by the crisis and subsidies to businesses, with a particular focus on small business. The programs, not all canvassed in this report, included programs of broad application and others targeting specific populations (Indigenous Peoples, youth), activities (e.g., environmental action in the oil and gas sector), and sectors (e.g., agriculture, fishery).

Income Support for Workers

The primary income support program, the Canada Emergency Relief Benefit (CERB), was generous by international standards at $500 per week. The CERB was delivered to nearly nine million Canadians during the six months of its operation. Its coverage was broad and included part-time, temporary and self-employed workers, independent and dependent contractors, and even workers eligible for Employment Insurance (EI) who had stopped working because of the pandemic. The Parliamentary Budget Officer estimates that the CERB cost approximately $80.7 billion from March to September, representing the largest single program in the government's arsenal.

Critics have suggested that the amount of the CERB created a disincentive for low income workers to return to work or find new work. The $500 weekly benefit was above the minimum wage in most provinces in Canada. Many workers, including part-time workers, were better off during the pandemic than prior to it. Some employers correspondingly were unable to fill vacancies as they sought to reopen their businesses.

As of October 2020, the government began transitioning most who had been on CERB to EI, while relaxing eligibility for EI in terms of both required hours and duration of work. For those still not eligible for EI, the new Canada Recovery Benefit (CRB) replaced the CERB. Initially, the government had proposed lowering the CRB to $400 per week but, as a result of a compromise with the New Democratic Party, the rate returned to $500 per week. The new CRB, together with parallel sickness and caregiver benefits, are estimated to cost some $23 billion over this and the next fiscal year. In the Fall Economic Statement, the government noted that 1.5 million Canadians had applied for the new benefit, which will be available until September 25, 2021.

Wage Subsidy for Employers

The Canada Emergency Wage Subsidy (CEWS) offered a subsidy of up to 75% of wages for employers that had incurred losses of revenue of 30% or more in the early months of the pandemic. The program was inspired in part by European experience that had focused on such intervention, with some early success, to foster continued attachment to the labour force.

The program, as designed, in part missed the mark. Uptake was low, and program costs were $14 billion lower than budgeted.

There was much criticism of the CEWS—too generous in some circumstances, not enough in others.

- It did not assist those businesses hardest hit by the pandemic who were forced to shut down. They had no work for their staff and could not afford paying 25% of salary when they earned no revenue.
- Usage was concentrated in mid-sized firms in a limited number of industries, with the manufacturing sector alone receiving 20% of all subsidies.
- It allowed some businesses that were profitable on an annual basis to receive a subsidy as long as they experienced a 30% loss of revenue in any one month.
- The calculation of the lost revenue and the determination of eligibility was complex for small businesses.

The CEWS has since undergone adjustments. It now includes a base subsidy for all employers whose revenues have been impacted by the pandemic, as well as a top-up subsidy for employers that are hardest hit. As well, the program was extended to June 2021.

Given the continued impacts of the pandemic on business revenue, the CEWS will be important for recovery of jobs. The adjustments to date have been generally well received by businesses and there has been an increase in the number of applications. The government estimates that the program to date has helped protect 3.9 million jobs, with over $50 billion in payments. As the economy recovers, it will be necessary to taper the program and eventually to retire it. Indeed, the downside of a wage subsidy program, in addition to its fiscal costs, is that it may sustain firms that have no realistic prospect of a return to profitability, so-called "zombie" firms.

Direct Supports to Businesses

The federal government's economic response to the pandemic also included direct supports to businesses that, while not tied to employment, helped cover operating costs, including labour costs. Again, a key objective has been to maintain businesses afloat until a recovery.

The key small business initiative, the Canada Emergency Business Account (CEBA) program, garnered a strong response. It delivered an interest-free loan with a forgivable portion of up to $40,000, with easy, quick access. Both the eligible loan and the forgivable amount were increased this fall, and the deadline for applications was extended to March 2021.[31]

It is noteworthy that the CEBA, together with the forbearance exercised by financial institutions on loan repayments, contributed to a significantly lower rate of small business insolvency in the first six months of the pandemic compared to the prior year. Insolvencies rose by 20% in September 2020, but they remain lower than the prior year.

Other programs for businesses generally were not as successful at delivering timely relief.

The Business Credit Availability Program (BCAP), intended to deliver to larger businesses financing at market rates that would be guaranteed by either Business Development Canada or Export Development Canada Bank, was beset by a number of challenges.

- Rules and process impeded timely access to, and delivery of, the needed assistance, particularly in the hard-hit energy sector.
- Businesses that were new or fast-growing before the pandemic did not have sufficient credit history or evidence of financial viability to be eligible for assistance.[32] This gap remains a concern because those are the firms that can drive the recovery and longer-term growth.
- While other financing programs were established or discussed to complement the BCAP and address the acute circumstances of large firms in the hardest-hit sectors, including airlines, or oil and gas, there was not the expected follow through. In the Fall Economic Statement, the government undertook to monitor this situation, and if appropriate, revisit programs available for the larger companies.

The commercial rent subsidy program, Canada Emergency Commercial Rent Assistance (CECRA), similar to the CEWS, initially had poor take up even though small businesses have suggested that rent is the single largest fixed cost. Although costs for this program were initially estimated at $2.97 billion, the Fall Economic Statement dropped this estimate to $2.16 billion.

The government redesigned its rent relief program to focus on tenant applications and a sliding scale of eligibility. The Canada Emergency Rent Subsidy (CERS), in force since the end of September and extending to March 2021, follows the same pattern as wage subsidy reform: basic support for most businesses that lost a minimum threshold of revenue, with a top up for those most significantly impacted by COVID. It is too early to know if the changes will increase usage.

The Fall Economic Statement announced added business supports. In particular, a Highly Affected Sectors Credit Availability Program (HASCAP) will be rolled out for the hardest hit businesses, including those in tourism and hospitality, hotels, arts and entertainment. The program will offer government-guaranteed financing and provide low-interest loans of up to $1 million over terms of up to 10 years. The program has not been costed.

Overall, federal government relief programs, not unexpectedly, involved some hits and misses in meeting immediate needs. Most of the programs, with some adjustments, are now planned to continue until well into 2021. Fiscal circumstances dictate that as early as permitted by the evolution of the pandemic, the government taper and ultimately retire the relief programs.

Looking Beyond the Pandemic: Re-Thinking the Income Safety Net, Adapting Skills

Policy attention must now shift from short-term relief to the enhancement of labour force participation, productivity and incomes in a post-pandemic world. The government ought to lay the groundwork now for a full review of Canada's income safety net for workers. Given that the best income security will always be a good paying job, governments, workers, and employers must also intensify efforts to enhance the skills of our workforce in line with the demands of the economy as driven by structural trends. The Fall Economic Statement did not yet signal this shift of policy attention. The considerations below may be pertinent in the context of the next budget.

The Income Safety Net

Reform of our income safety net is timely—indeed long overdue—for several reasons.

- **The last major, comprehensive external review was done by the Macdonald Commission in 1985** —before the advent of the internet, and in a very different socio-economic and political context.
- **Clearly, EI was not up to the task of responding to a deep and widespread economic disruption and delivering adequate support in today's labour market.** It showed its many limitations in both design and delivery. Eligibility rules were complex with thresholds that would have left many (e.g., gig economy and self-employed workers) without income. Technologically, program administration was unable to deal with the anticipated volume of requests for benefits —thus the shift to the blunt CERB delivered through the tax system.
- **The federal emergency programs delivered critical support and they will not be retired easily, but they are not the foundation for an effective, sustainable social safety net.** Some have suggested that the CERB could be a pre-cursor of a guaranteed basic income. However, any such initiative would have to be placed into a wider context and consider the impacts of a new permanent program on the labour market, relationships with other federal or provincial programs (e.g., housing, child care), and fiscal costs.
- **Because of the changing nature of work, growing income inequality and the rise in part-time, temporary and gig work, many western countries are assessing their income support policies and programs.** The federal government recently released a limited external expert report that looks at modernizing employment standards, but it has not commissioned an external review of employment insurance and other income support programs.

A place to start would be a reform of EI. The government to date has insisted that pandemic-related EI enhancements are temporary, but it has not indicated what form the post-pandemic EI will take. It is time to reassess, in particular, whether the employment insurance, special leaves and training supports should remain part of a single EI program. A reform could pursue less complex, flexible rules to take into account the changing nature of work, a review of regional variations in benefits, and modernization of the delivery infrastructure (IT and data systems) to accommodate a more responsive, scalable and resilient program.

In fact, a review of the income safety net is more complex still, requiring collaboration with provinces. Income security is a matter of shared jurisdiction in Canada. The federal government delivers income support through a variety of programs, including EI. The provinces provide the ultimate backstop through social assistance programs. They are also on the front lines of education and training. Over time, the lines between federal and provincial programs have become blurred. Programs overlap, they are not well integrated, and they may leave important gaps.

An expert review of the income safety net could be mandated to develop solutions that not only better meet social needs but that also would contribute to a healthier labour market and a stronger economy. A full review could consider the major programs that currently exist, identify gaps, and make proposals for reform. The review should be subject to a tight timeline (e.g., 18 months) to ensure that the exercise is focused and productive and that it deliver avenues for reform that could be actionable as Canada emerges from the pandemic and builds a new future.

The Government of Canada should strike such a review now for advice to be ready by mid-2022.

Productivity and Skills Training

As high unemployment is expected to persist until 2022, as some jobs are unlikely to return, and as the jobs of tomorrow will be different than the jobs of today, governments, employers and workers need to use this time to adapt and improve skills.

Indeed, looking ahead, the challenge for employers is not a generalized shortage of labour, or inflation of wages, but the matching of employment opportunities with the skills available in the market. As the pandemic subsides and as jobs are created, the pull back of emergency support measures, the reopening of schools enabling return to work of parents, and the resumption of immigration flows will contribute to more normal market conditions.[33] However, absent dedicated efforts, the skills mismatch already prevalent before the pandemic could become more acute.

There are two priorities for skills development.

- **First, there must be attention to workers who risk long-term employment or the permanent loss of jobs in their sectors.** For example, airline workers may be sidelined for an extended period of time and it is uncertain what a new normal will be in the sector. It is best that affected workers be retrained, for example building on their skills to address acute needs in the long-term care sector. Consideration could be given in parallel to improving wages and working conditions in this sector to attract new, retrained workers.
- **Second, integrated strategies must be in place to build the workforce of the future.** This is not a matter of a single new program. The federal government has stated it will support skills training for the green economy, but it is unclear how many jobs that will support, and what specific type of work is contemplated. The question is much broader. For example, the pandemic has made clear, if ever in doubt, that skills for the digital economy, including data analytics and programming, will come at a premium. A strategy must guide workers and employers and ensure that the program infrastructure is up to the task.

A skills strategy must target a wider population than those eligible for EI-funded programs. Individuals who are not eligible for EI, who worked reduced hours prior to the pandemic, or who exited the workforce during the pandemic should all be candidates. This would apply particularly to women and seniors who were not able to work during the pandemic.

Since most of the federal skills training funding are delivered through labour market agreements with the provinces, a federal-provincial dialogue needs to take place. This fall, the government announced increased funding of $1.5 billion for these agreements in 2020-21, but it has not outlined how improved results may be delivered. Governments have to ensure these programs are cost-effective with clear benchmarks of success, engage the private sector, are readily accessible to the unemployed and reduce inter-provincial barriers to labour mobility.

V. Government and the Delivery of Policy

The Necessary Contribution to Productivity Growth

Highlights

A shift from consumption to investment, together with strategic focus, and competent design and delivery, are necessary conditions for government policy to make a stronger contribution to productivity growth.

There are opportunities to pursue improved policy outcomes, in particular, through:

- a strategic, long-term approach to infrastructure, with strong private sector participation;
- a regulatory system that is streamlined and that is more supportive of innovation and competitiveness;
- a digital transformation of government, for example a digital I.D., that could serve the wider economy and, with strong public and private sector leadership, create competitive advantage for Canada.

Governments are called upon to support individuals and businesses in the recovery from the COVID crisis while also creating the foundation for a stronger economy.

It matters not only *how much* government is spending, but critically *how* it is spending or intervening in markets: whether the design and delivery of programs are effective and whether they are supporting investment and productivity growth. A shift of government expenditure from supporting consumption to investing in productive capacity is a necessary discipline. Strategic focus and competent follow through are other key conditions for effective action.

Opportunities for improved results may be pursued in such domains as infrastructure, regulation, and digital transformation.

Governments and Productivity

Every Speech from the Throne and every government budget lays out a (sometimes long) list of policy commitments. Typically, governments will set out the spending envelopes, the key parameters of the programs, and the economic, environmental, social, or other target outcomes.

In some cases, the design and delivery of government initiatives is straightforward. For some transfer programs, once eligibility rules and entitlements have been determined, and once authority is granted, money can flow quickly to recipients and achieve results. For example, a one-time supplement to the Canada Child Benefit can be executed readily.

However, implementation is more difficult when initiatives require a careful determination of rules and/or a new program infrastructure for delivery. There can be months, sometimes years, between an announcement and the achievement of results. Many initiatives fail to deliver on their promises, or they may later be sidelined by shifting priorities.

The capacity of governments to deliver has been stretched through the pandemic. We have seen in the prior chapter that some elements of the federal government response have been delivered promptly and that others did not materialize as promised. For example, the Large Employer Emergency Financing Facility (LEEFF), has been largely undersubscribed because of complex rules and unattractive terms for businesses. There will be a time for conclusions to be drawn, and lessons to be learned. The point is that beyond the intent of policy pronouncements, design and delivery matter critically for results. This is true in this time of crisis. It will be true beyond it.

The multiplicity of government initiatives can also distract from the critical requirement for the government and for the country to raise productivity growth as the enabler of other pursuits. Impact on investment and productivity should be a prism through which to assess all interventions.

Thus, as governments look beyond the pandemic, there is an opportunity to focus on a finite set of priorities, to pay consistent attention to design and execution, and to place productivity growth at the centre of the agenda. This would not only contain fiscal costs, it would ensure that results may be realized that will be in step with the needs of a more productive, competitive economy. By contrast, a crowded and scattered agenda will be poorly executed, and it will weigh the economy down. Mobilization of the private sector will be important to align interests and strategies, to design and execute policy effectively, and to advance together public and private interests.

Infrastructure: Getting a Better Bang for the Buck

Public investment in infrastructure typically looms large in the strategy of governments to overcome recessions. In the classical Keynesian framework, it is a tried and true means of supplementing demand and creating jobs. Indeed, it was a major element of the response to the 2008-09 Great Recession.

Governments again have an opportunity to accelerate plans already drawn up for investment in economic and social infrastructure. In particular, support for expansion of broadband capacity will strengthen participation in the digital economy and make online access to key public services such as education and health care more accessible to citizens.

There are some differences, however, with this recession.

- **The construction industry is not among the sectors hardest hit and its recovery, while not complete, has been strong.** Moreover, workers in the sectors most affected by the pandemic —including a large proportion of women in the tourism and hospitality sectors—are not trained in the construction trades. Thus, bolstering public infrastructure may yield more limited short-term dividends.
- **Governments, in particular provinces and municipalities, are not in the same position as in 2008-09 to contribute financially to a ramp up of infrastructure spending.** Provinces are facing sharply rising debt. Municipalities have incurred large hits to their revenue. While the federal government has a larger capacity to borrow, it has already heavily utilized this capacity and it must be judicious going forward.
- **Structural trends require that Canada build new productive capacity:** to get our resources and products to markets, to adapt our energy system to a low-carbon future, to adapt to the digital economy. This is a different exercise than spreading funds to all communities, and funding shovel-ready projects for short-term stimulus.

There must, therefore, be a deliberate strategy to identify priority infrastructure and to design and deliver projects for long-term economic gain.

First, there should be an acceleration of decisions for proposed transportation and trade corridors and energy infrastructure projects that may be funded entirely or principally by the private sector. Where reviews and consultations are advanced, and appropriate conditions set, early decisions can expand trade and bolster resilience by creating added options for both domestic producers and importers.

Second, as underscored by Economic Strategy Tables of business leaders from a wide cross section of our economy, there should be a strategic approach to infrastructure, and rolling long-term plans.[34] Infrastructure such as transportation, energy, water and broadband constitute integrated systems that are more than a collection of projects to be considered sequentially. Governments, in consultation with industries and communities, can guide investment to where it may capture economic opportunity, resolve bottlenecks, and capitalize on emerging technology.

Third, for some infrastructure, there may be an opportunity for collaboration with the United States on integrated cross-border systems. The only chance of salvaging Keystone XL against the stated intention of President-elect Biden to rescind the U.S. permit is earliest engagement on wider, shared Canada-U.S. interests on energy and climate.

Fourth, long-term plans have to integrate both Canada's interests as energy exporter and the transformation of the global energy system toward a lower carbon, and by mid-century, a net-zero emission future. The prosperity of Canada and its regions depend on realizing value from our resources. This includes ensuring access to markets for oil and natural gas (e.g., LNG) while there is still large—if diminished—global demand. At the same time, Canada can accelerate electrification of its economy and grow the share of non-emitting energy supply (including nuclear). Importantly, it can pursue innovation in the energy sector to capture and use emissions and to build hydrogen infrastructure. This is consistent with the stated agenda of a Biden administration. In some cases, government aid will be required to get investments across a finish line. The pre-condition is a strategic vision, planning, and a rigorous and timely assessment of benefits, costs, and risks. Facts and analysis should have greater weight than political calculus.

Fifth, governments should attract private participation in public infrastructure. The Canada Infrastructure Bank (CIB) is an example of a government initiative that to date has failed to live up to its promise. With a new chair and CEO, it is time for the government to give it the room to get projects done. Given fiscal circumstances, provinces and municipalities may now be more disposed to imposing tolls on roads, bridges, or highways. Meanwhile, institutional investors can be attracted to the long-term, stable streams of income. With the right design, and with private sector discipline, infrastructure can deliver public benefits with lesser impact on public deficits and debt.

Altogether, a strategic approach to infrastructure, with strong private sector participation, will go a long way toward making the best contribution to long-term prosperity.

Regulation: Achieving High Standards at Lower Costs

Canada's complex regulatory system is consistently cited by business leaders as the number one policy barrier to Canada's competitiveness. International rankings also place our system in poor light.[35] Regulation deserves at least as much attention as taxation, in fact more, to drive productivity gains.

What is typically at issue in Canada is not the underlying objective of regulation or the expectation —widely accepted—that firms meet high standards of performance, but rather uncertain or shifting goal posts and the deficient operation of the regulatory system:

- the concurrent pursuit of a multiplicity of regulatory initiatives with uncertain cumulative results;
- the unpredictable and drawn out timelines for review and decision;
- the overlapping of federal and provincial rules, and regulatory fragmentation across the country;

- a propensity of regulators to minimize rather than manage risk and, in so doing, to shift risk, for example to the longer term; and
- correspondingly, an aversion to innovation.

There have been and continue to be efforts in some jurisdictions to cut "red tape", but there is now urgency to raise the level of ambition for regulatory reform.

- **The demand for regulation to protect and promote the public interest is not going away; if anything it may increase.** With government shown again through this crisis to be the ultimate insurer against everything from pandemics to financial crises, regulation is the manifestation of the responsibility that such risks be managed. There is also the expectation of citizens that government is doing what it takes to protect their health, their environment, the safety of their food, and their rights and interests as workers and as consumers. Climate change is one, among emerging issues, creating pressure for added regulation.
- **Technology poses new challenges but also opens up possibilities for more agile, efficient regulation.** Regulators around the world are seized with the need to adapt regulation to the digital economy: everything from competition, to tax, to privacy and security. At the same time, real-time data and faster networks create opportunities for industry and governments to collaborate on new approaches to regulation in such domains as border management, transportation safety, environmental stewardship, or financial stability.
- **With other major economies pursuing their regulatory agenda to further both the public interest and competitiveness, Canada has to develop its own strategy.** The European Union is acting on a wide range of fronts, notably in the digital economy. A Biden administration will likely reverse the deregulation thrust of the Trump administration and it will be perceived as less business-friendly. However, like all prior administrations, it will be mindful at every step of the global competitive playing field. On climate, jurisdictions internationally will also be attentive to the opportunities for their firms to succeed globally. Canada's regulatory strategy in this competitive environment is not always discernible. We have to get in the game.

In short, better regulation should be at the heart of the agenda of federal and provincial governments for a stronger economy. This requires both clear direction from political leadership as efforts across the regulatory system to streamline, innovate and pursue better outcomes.

Regulators and industry together can pursue a range of approaches. In particular:

- shifting from prescriptive to **outcome-based regulation** that offer a wider range of compliance options and that create greater space for innovation;
- creating **regulatory "sandboxes"** to test new regulatory approaches in a streamlined but controlled fashion;
- harmonizing rules across provinces and getting serious about **internal free trade**, with more assertive federal leadership; and
- where interests are aligned, pursuing **harmonization with the United States**, giving new momentum to initiatives that favor a Canada-United States or North American perimeter.

In some cases, this will require that governments invest in the capacity of their regulatory bodies. Regulators need the resources to access talent, to modernize their information systems and their databases, and to engage with businesses and with the public. Modest budgetary savings from freezing those budgets will impose greater costs on the economy.

Digital Transformation of the Economy: The Government's Critical Part

Like all large organizations, governments will have learned through the COVID crisis that they have to accelerate the digital transformation of their business. This is considerably more ambitious than going paperless. It is about taking full advantage of the power of data and networks to improve productivity and to provide better services to citizens. This opportunity cuts across all domains of government, from health care and education, to the regulation of the economy.

In addition to getting their own house in order, governments have a wider responsibility to create the infrastructure for Canada to realize the benefits of digital transformation. Public investments in broadband is rightly a priority. That is the hardware. Governments, in concert with the private sector, also have to establish the policy and institutional infrastructure for the digital space—the governance and rules that will give the right assurances of privacy, safety, and security. That is the software. There can be no data-enabled health care sector, modernized payments system, or any prospect of a central bank digital currency without public sector leadership.

Thus, government holds many of the keys to the productivity gains that may be realized in the digital economy. Canada must capitalize on Canadian strengths, notably talent, to create competitive advantage—drawing on the capabilities of our home-grown firms to find new solutions that may be deployed domestically and then exported internationally.

One critical lynchpin of more efficient e-government as well as e-commerce is digital identity. A digital ID represents in the digital environment the equivalent of our passport, driver's license, or health card—and indeed could encompass all of the above.

A unique digital ID could facilitate access to all government services—federal, provincial, and local. With the right systems and rules, services could be provided privately, securely, and seamlessly across government. Citizens could also be in better control of their private data, and less vulnerable to cyber-risk.

In the marketplace, digital ID would be a foundation for more efficient and secure transactions. Consumers today establish their identity with a multiplicity of parties by sharing personal and financial information that then resides on multiple servers. Meanwhile, the safekeeping and manipulation of a panoply of ID's and passwords is a source of static. A unique digital identity would be a key step in solving these issues. As recognized by the Bank of Canada and other major central banks, it would also be a pre-requisite for a central bank-issued digital currency.[36]

The Digital Identification and Authentication Council of Canada, a coalition of public and private sector leaders, has set out a five-year strategic plan, but there is yet no compelling direction.[37] The strategic plan cites as first goal to "obtain senior recognition in governments of the importance of digital ID", hardly the expression of a national priority.

Canada has to aim higher and faster on digital transformation and this will require strong public and private sector leadership. If Canadians together do not take ownership, then solutions will be defined by global competitors and we will at best succeed in importing best practises. A system of digital ID could begin to forge this necessary alignment of interests in Canada.

Notes

1. See International Monetary Fund, *World Economic Outlook*, October 2020. https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020#Chapter%201:%20Global%20Prospects%20and%20Policies

2. As reported by Jonathan Wheatley, *Pandemic fuels global 'debt tsunami'*, Financial Times, November 18, 2020. https://www.ft.com/content/18527e0c-6f02-4c70-93cb-c26c3680c8ad

3. See International Energy Agency, *World Energy Outlook 2020*. https://www.iea.org/reports/world-energy-outlook-2020

4. See OECD, *Economic Outlook*, December 2020. http://www.oecd.org/economic-outlook/december-2020/

5. See Karen Weise, *Pushed by Pandemic, Amazon Goes on a Hiring Spree Without Equal*, New York Times, November 27, 2020. https://www.nytimes.com/2020/11/27/technology/pushed-by-pandemic-amazon-goes-on-a-hiring-spree-without-equal.html

6. See Vivian Hunt, Bruce Simpson, and Yuito Yamada, McKinsey & Company, *The Case for Stakeholder Capitalism*, November 2020. https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-case-for-stakeholder-capitalism

7. Jay Powell at the virtual annual forum on central banking, November 12, 2020, *Financial Times*, November 13, 2020.

8. Aggregates are not always equal to the sum of their components.

   At the lowest level of detail, it may not be possible to produce a homogeneous series from 1997 to the present. Only industries and certain aggregates that provide good continuity back to 1997 have data from 1997 to 2006.

   Effective November 30, 2018, the data is presented on a 2012 reference year basis.

   The alphanumeric code appearing in square brackets beside the industry title represents the identification code of an aggregation of NAICS industries, whose definition is included in the full classification provided in the definitions, data sources and methods for the statistical program 1301 - Gross domestic product by Industry - National (Monthly).

9. Monetary Policy Report Press Conference Opening Statement, October 28, 2020.

10. Bank of Canada press release, October 28, 2020.

11. The operational control objective is to keep inflation close to the 2% target, the centre of a 1% to 3% band. See "Bridge to Recovery: the Bank's COVID-19 Pandemic Response", speech in Toronto on May 4.

12. IMF, *Fiscal Monitor*, *Database of Country Fiscal Measures in Response to the COVID-19 Pandemic*, Figure 1, October 2020.

13. Fall Economic Statement 2020, p. 23. This ignores $85 billion in tax and customs duty payment deferrals and $52 billion in support for coordinated federal, provincial and territorial action to strengthen health care systems, purchase personal protective equipment and support medical research and vaccine development.

14. See International Monetary Fund, *World Economic Outlook*, October 2020, Chapter 1. https://www.imf.org/en/Publications/WEO/Issues/2020/09/30/world-economic-outlook-october-2020#Chapter%201:%20Global%20Prospects%20and%20Policies

15. See a recent blog post be Jennifer Hillman to the Council on Foreign Relations entitled: *To Address Climate Change While Protecting Workers, the United States Needs a Border-Adjusted Carbon Tax*. Hillman has been a senior American trade official and served on the WTO Appellate Body. https://www.cfr.org/blog/address-climate-change-while-protecting-workers-united-states-needs-border-adjusted-carbon-tax?utm_medium=social_share&utm_source=tw

16. An independent policy note by Agri-Food Economic Systems explores the interdependence of North American agri-food trade in some detail: http://www.agrifoodecon.ca/uploads/userfiles/files/us%20agri-food%20trade%20nafta(1).pdf

17. It is worth noting that of the four ASEAN countries that signed the CPTPP so far, only two have ratified the agreement. The CPTPP was signed March 8, 2018, and came into force on December 31, 2018. Brunei, Malaysia, Singapore and Vietnam were original signatories but only the latter two have so far ratified. Ratification by Brunei and Malaysia does not appear to be imminent. It is unclear how long it might take six ASEAN countries to ratify the RCEP.

18. See Statistics Canada, *International Merchandise Trade for All Countries and by Principal Trading Partners*, Monthly, Table: 12-10-0011-01. https://www.international.gc.ca/economist-economiste/performance/monthly-mensuel.aspx?lang=eng#:~:text=Goods%20exports%20and%20imports%20remain,%2Dpandemic%20(February)%20levels.&text=Stripping%20out%20price%20impacts%2C%20goods,to%20%243.3%20billion%20in%20September

19. See, for example, *Launch of the 2019 Skills Outlook: Thriving in a Digital World,* Remarks by Angel Gurría, Secretary-General of the OECD, 9 May 2019, https://www.oecd.org/about/secretary-general/launch-of-2019-skills-outlook-thriving-in-a-digital-world-paris-may-2019.htm

20. OECD Report (November 2020). Canada's unemployment rate in September was 9% compared with an overall OECD average of 7.7%. See: http://www.oecd.org/sdd/labour-stats/unemployment-rates-oecd-11-2020.pdf

21. See Statistics Canada: Table 14-10-0355-01, Employment by industry, monthly, seasonally adjusted and unadjusted, and trend-cycle, last five months (x 1,000), and Table 14-10-0289-01, Actual hours worked at main job by industry, monthly, seasonally adjusted, last five months (x 1,000).

22. See Statistics Canada, *The Daily,* June 6, 2020: Labour Force Survey, May 2020; https://www150.statcan.gc.ca/n1/daily-quotidien/200605/dq200605a-eng.htm

23. Matt Lundy, *Globe and Mail*, "The Labour Divide: Eight Charts that Explain Canada's Uneven Job Recovery", October 28, 2020.

24. See Statistics Canada, Table 14-10-0342-01 Duration of unemployment, monthly, seasonally adjusted.

25. See Statistics Canada, Canadian Survey on Business Conditions: Impact of COVID-19 on businesses in Canada, May 2020, https://www150.statcan.gc.ca/n1/daily-quotidien/200714/dq200714a-eng.htm?CMP=mstatcan

26. See Statistics Canada, *The Daily,* November 6, 20202: Labour Force Survey, October 2020, https://www150.statcan.gc.ca/n1/daily-quotidien/201106/dq201106a-eng.htm

27. The absence of childcare and school during the pandemic is thought to be a primary reason for the decrease in female workers. While primary and secondary schools opened in the fall of 2020, September's enrolment in regulated childcare was 37% of pre-pandemic levels. As well, the uncertainty of continued school attendance has made it more difficult for women to return to work. Finally, after school care remained in short supply even after schools re-opened.

28. The wage gap between men and women closed during the pandemic at a significantly faster pace than in previous years. Between February and September, the gap between average male and female wages fell by 1.7%. While this may appear as a positive outcome, it is likely explained by the fact that women in low wage jobs are either unemployed or have exited the workforce, leaving only female comparators in relatively higher paying jobs.

29. Gingrich and Mitchell, COVID-19, the Canadian Labour Market, and Women, September 11, 2020, https://glrc.info.yorku.ca/2020/09/covid-19-the-canadian-labour-market-and-women/

30. Faraday, Women on the Front Lines, Broadbent Institute Digital Convening Series, April 22, 2020, noted that 36% of Ontario cases of COVID were women working in high risk essential health care.

31. The enhancements comprise an additional loan amount of up to $20,000, with up to $10,000 of that amount being forgivable.

32. V. Subramaniam, "'It Feels Like We Are Being Punished: Companies Not Yet Profitable Struggling to Access Government Loans," Financial Post, April 9, 2020.

33. The severity of the impact of the pandemic on immigration cannot be underestimated. New temporary immigration permits fell by 35% over the previous year and lower immigration could reduce Canada's population growth to 1% instead of 1.4% in the prior year.

34. See Report (to Government of Canada) from Canada's Economic Strategy Tables: Seizing Opportunities for Growth: September 25, 2018: https://www.ic.gc.ca/eic/site/098.nsf/eng/00027.html

35. For example, as observed by Canada's Economic Strategy Tables, Canada ranks 34th out of 35 OECD countries in the average time to receive project construction approval.

36. See Central bank digital currencies: foundational principles and core features. Paper issued jointly by the Bank of Canada, the Bank for International Settlements, and six other major central banks, October 9, 2020. https://www.bis.org/publ/othp33.pdf

37. See Digital Identification and Authentication Canadian Council, Five-Year Strategic Plan, October 2020, https://diacc.ca/2020/10/27/the-diacc-five-year-strategic-plan/

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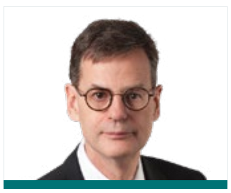

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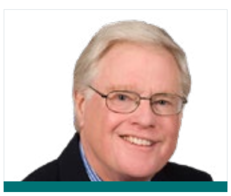

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